AUDITING

An Introduction

To the Work of the
Public Accountant

by

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Preface

This book is the successor to *Principles of Auditing*—now out of print—by the author and his former associate, Paul W. Pettengill. Although the chapter outline is similar, the whole text has been completely rewritten and much new material has been introduced. The "illustrative audit," an earlier version of which formed the second half of the old volume, has been put into a separate binder, thus permitting easier reference and frequent replacement.

It is possible that the present book, like its predecessor, may find utility not only as a textbook but also as an aid in setting minimum-practice standards in public-accounting organizations having need for a summary manual. In draft form, various sections of the book have already served both uses. By hewing to the line of basic principles and procedures the author has endeavored to keep within the requirements of brevity which these uses demand.

Audit procedures of public accountants have not changed materially during the past decade, but a different emphasis has been given from time to time to existing practices. It is now considered essential that the auditor be present when a physical inventory is taken and that he seek the verification of receivables by correspondence; but these practices were standard in many firms and were advocated in *Principles of Auditing* and elsewhere long before the McKesson and Robbins fraud of 1938 brought about their reconsideration and wider adoption by the profession.

One function of the auditor that has steadily increased in importance with the years is the assistance he gives to management in maintaining and improving internal controls, especially at top levels, raising accounting and reporting standards, and solving financial and other business problems. This function frequently extends beyond the concepts conventionally associated with accounting and auditing, yet the development has been a natural one. The professional auditor, an annual observer of the operations of many enterprises, whose views are tinged with an ever-increasing public interest, and who must always insist on putting the maximum of information and interpretability into published operating results, has come to be regarded by his clients as well fitted to give sage counsel on almost any business matter. It is essential, therefore, that the auditor's techniques be broad-gaged and yield the greatest possible amount of general operating information: for his

own protection, to be sure, as insurance against an unqualified certificate, but also so that for others he may analyze correctly and advise wisely. The primary responsibility of the accountant of the future may well be *interpretation* rather than *verification.* In the pages that follow, particularly in Chapter IV, practical implications of this growing function have influenced the subject matter.

A new emphasis also attaches to the examination of profit-and-loss details. Despite frequent references to the increased importance that the auditor ought to attribute to the income statement, little of significance has emerged in the way of suggestions for modifications of audit procedures. In this respect, the comments on operations in Chapter V represent something in the way of a departure from the usual textbook treatment of the subject. The author's experience points to the need for examining the causes behind the profit-and-loss accounts: an inquiry pursued for the most part by directing questions at management and by scanning. Through a comprehensive carrying out of such processes, the author has found that a sharper meaning is imparted to individual and collective income and expense accounts, and to many real accounts as well; and that their fluctuations as between years are more likely to be accurately understood and intelligently described.

Basic accounting is, of course, a prerequisite for the study of auditing: an auditor is expected to have a thorough grounding in accounting theory and an ability to give it sensible application. A product of his training must be a lively appreciation of procedural problems to which professional groups have given or are likely to give consideration. At frequent points in the text these problems are outlined and an attempt is made to develop in the reader a consistent, long-range point of view regarding them.

In the *Illustrative Audit* the reader may observe practical demonstrations of many of the points made in each chapter of this book, and he is urged to examine, concurrently with the text, the related working papers. By so doing he should add much to his understanding of the meaning of auditing.

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Chicago, Illinois
January 1947

Contents

CHAPTER I

The Meaning of Auditing

The work of the certified public accountant is firmly established as an indispensable service to the world of business. A member of a dignified and respected profession, the accountant is responsible not only to the interests by whom he is employed but, in an ever increasing degree, to investors, to government, and even to the general public. His knowledge of business practices and relationships must be extensive, because accounting and accounting controls permeate practically every business activity and are always closely linked with other management controls. And, as the periodic reviewer of the accounting and financial policies of an individual enterprise, he often finds himself squarely in the midst of problems commonly associated with the fields of management and business ethics. His function is of the first importance to society at large, for he is the only outsider who annually appraises and reports on any aspect of business operations. Moreover, his findings, in the case of larger and even many smaller business enterprises, are required by custom, law, and regulation to be made public in reports, the scope and language of which are of his own choosing.

Because his fee is paid by the organization on which he is reporting and because of an ever-present potential of competition, no matter how slight, between himself and other members of the profession, the public accountant is sometimes suspected of bias in favor of the management of the organization that employs him, and thus of not being wholly objective in his approach and in his findings. That such a bias has actually existed in particular instances it would be idle to deny. But the profession has made earnest efforts to forestall it by devising and publicizing accounting and auditing standards, improving state laws which prescribe qualifications for entry into the profession and govern the issuance of licenses to practice, and coöperating with such public and quasi-public bodies as the Securities and Exchange Commission and the New York Stock Exchange in their endeavors to raise the sights of business. In recent years, particularly during the war years, public accountants have been called on by regulatory bodies and

other agencies of government to furnish special information that they have needed, thus obviating independent investigations and fact-findings by these agencies. Reliance by public bodies on information thus secured has had the effect of still further strengthening the objectivity of the accountant's relations with business enterprise. Improvements in the accounting process as a whole may, in fact, be observed as a direct result of every increase in this objectivity.

Scope of Auditing

Professional accountants have wide and varied activities. The most frequent use of their services is in annual examinations that precede the issuance of corporate financial statements to stockholders and regulatory bodies: examinations commonly referred to as annual or balance-sheet audits, the outline and discussion of which is the object of this book. The preparation of income-tax returns and the review and assistance given in connection with income-tax problems also find an important place in the work of every public-accounting firm. Other activities consist of advice on financial and management policies and problems, the installation and revision of accounting and cost systems and of budgetary methods and schemes of internal control. Many business managements defer embarking on new ventures until they have reviewed with their accounting advisers the practicality of the plans and the possible effects that may result.

Very little is done by the professional accountant today that does not carry with it a responsibility to persons other than the client immediately served. In his certificate or report, following a balance-sheet audit, the accountant nominally addresses the management, directors, or stockholders; but he knows that once the financial statements have been published with his certificate attached, his responsibility inevitably reaches out to third parties.

The Certified Public Accountant

Like members of other professions, the certified public accountant is licensed by the state after he has successfully passed a written examination. State laws take numerous forms, but most of them have at least three prerequisites for the examination: a minimum age, a minimum education, and a minimum number of years of experience in the field of accounting. Twenty-one is the usual age minimum, graduation from high school the most frequent educational standard, and three years in the office of a certified public accountant a typical experience requirement. There has been a growing tendency to increase the educational minimum, a few states demanding accounting instruction at the college level,

and even graduation. Frequently, a deduction can be made from the experience requirement for academic work.

More than forty of the states now present the same examination in May and November, prepared by the board of examiners of the American Institute of Accountants. The subjects are accounting theory, accounting practice (two sessions), auditing, and commercial law. Some state laws require an examination in such other subjects as governmental accounting and economics. Many of the papers are graded under the auspices of the AIA board of examiners. A few states continue to give independent examinations, but their scope and difficulty are on a par with the uniform examination. Any person who aspires to be a member of the accounting profession should qualify himself as a certified public accountant.

Training for the profession may be pursued by full-time attendance at numerous institutions of higher learning, by evening-school work in larger communities, by correspondence, or by a combination of these methods. Courses of instruction having immediate importance to accountants consist of accounting principles and practices, income taxes, business management, corporation finance, statistics, and business law. Equally important, of course, are courses designed to fit the accountant to be an intelligent, responsible member of society: the social, physical, and biological sciences, history, literature, English composition, and public speaking. His minor accomplishments, which, however, are quite essential to his entrance into the public-accounting field, should include an ability mentally to perform arithmetic operations quickly and accurately and a fair facility in the use of several types of adding and calculating machines. It may be too much of a strain on the prospective accountant's character to ask that his handwriting be more than barely legible, but, regardless of his script, his figures must be clearly and firmly made.

These characteristics may be imposed on an intelligent individual by training. But there are a number of personal attributes that experience has shown to be even more fundamental: a well-developed imagination tempered by a good store of common sense, a liking for detail and analysis that has been well disciplined by an ability to generalize and draw convincing conclusions, and a continuous supply of idealism that continues to flow, notwithstanding the mundaneness of the accountant's daily contacts and the growth of his earning capacity. Implied in this last quality is intellectual honesty; the accountant must live up to the performance demanded by professional standards and the instructions of his superiors, and he must also have a courageous conscience. He must not permit himself to be persuaded to do or not to do a certain thing in violation of his convictions.

Once the prospective accountant enters the employ of a member of the profession, he acquires the lessons of practical experience: how to adapt himself to his surroundings without carping at things not to his fancy, how to be tactful in his dealings with others, how to secure information and decisions from superiors or from members of a client's staff without proving himself a nuisance, how to be self-possessed and tactful under trying circumstances, and how to determine the relative importance of the things he discovers when he examines books of account.

Professional Ethics

The American Institute of Accountants, with its predecessor, the National Association of Public Accountants, has been in existence as a national professional body since 1887. In 1936, by merging with the American Society of Certified Public Accountants (which had been established in 1921), it became the one national organization of professional accountants. Its bylaws provide that its objects are:

> * * * to unite the accountancy profession of the United States; to promote and maintain high professional and moral standards; to assist in the maintenance of high standards for the certified public accountant certificate in the several states; to safeguard the interests of public accountants; to advance the science of accountancy; to develop and improve accountancy education; to provide for the examination of candidates for membership; and to encourage cordial intercourse among accountants practicing in the United States of America.

In addition to the American Institute of Accountants, there are societies of certified public accountants in each of the forty-eight states, the District of Columbia, the three territories, and the Virgin Islands. Most of them are loosely affiliated with the national organization.

Many of these professional organizations have codes of ethics. Like other professional codes, they are designed to keep the profession on a dignified basis, to protect members in their relations with each other, and to provide some degree of assurance that the profession in its service to the public will maintain a high level of responsibility and performance. The code of the American Institute of Accountants, officially designated *Rules of Professional Conduct,* consists of sixteen articles; an "infringement" of any of them may lead to suspension or expulsion from the Institute. A summary follows.

1. Accounting firms may use the phrase "Members (or Associates) of the American Institute of Accountants" on their stationery and elsewhere, under specified restrictions.

2. A member may not permit another person to practice in his name who is not a partner or employee.

3. Members are prohibited from accepting fees or commissions on work performed by outsiders upon members' recommendation, or from paying fees and commissions to others for securing professional work.

4. A member operating jointly with a public accountant may not carry on any activity in conflict with the profession.

5. In or accompanying financial statements audited by a member, there must be a disclosure of every material fact the omission of which might mislead the reader, of any material misstatement, or of any material departure from "generally accepted" accounting principles or applicable audit procedure; and the opinion of a member as to financial statements may not be given on the basis of inadequate information or where his exceptions have the effect of negativing his opinion.

6. A member's signature on an audit report is prohibited where the audit has not been made by the member, an employee, or other duly qualified accountant.

7. Solicitation of business is prohibited, but only where it encroaches on the work of another member.

8. Employment may not be offered to an employee of another public accountant without first informing the employer, unless the employee seeks a change on his own initiative or in response to an advertisement.

9. Contingent fees are permitted in tax cases, but prohibited elsewhere.

10. Advertising is prohibited, and professional announcements (of personnel of firm, or of change of address) are subject to specific restrictions.

11. Members are not permitted to be connected with any corporation engaging in public-accounting practice.

12. A member may not subscribe to the accuracy of an estimate of future earnings or permit any inference to that effect.

13. A member may not certify to the financial statements of an enterprise, financed by a public distribution of any of its securities, in which he or one of his family has an interest, provided the interest is "substantial either in relation to its [the enterprise's] capital or to the individual's personal fortune."

14. Competitive bids are forbidden only when in violation of rules laid down by state or other local accounting boards or societies.

15. A member engaging in public accounting and in some other occupation is required in both capacities to observe the Institute's rules.

16. There must be no violation of the confidential relationship between a member and his client.

Legal Liability

As a member of a profession, the accountant must accept full responsibility for the service he renders. A number of states forbid incorporation or any other attempt on the part of the accountant to avoid pecuniary liability for his professional acts. On several occasions accountants have been sued by persons claiming damages allegedly arising from their reliance on financial statements to which the accountants had certified, but most of these cases have involved extreme carelessness or doubtful issues from which general conclusions are difficult to draw. However, the following points appear to be well established:

1. Since he holds himself out to the public as an expert, the accountant may not neglect to perform his work with the same degree of skill as would be exercised under similar conditions by any conscientious member of the profession.

2. Ignorance of any usual audit standard or procedure cannot excuse the accountant from liability. The public has the right to expect from him performance of a high order and reasonable care in all he does.

3. A mistake that might be made by any accountant working under similar conditions cannot be regarded as giving rise to liability, but the mistake must be an "honest" one, untainted with any yielding to the wish of a client or with any other unprofessional act.

4. Inexcusable errors, which give rise to negligence with respect to the client, may involve fraud with respect to third persons.

5. Essential facts must be disclosed. Professional custom rather than his own judgment should be the accountant's determinant of what "essential" means.

6. Where, during the course of his audit, the accountant finds cause for suspicion, he must thereupon institute a sufficiently thorough investigation to lay bare the details of the irregularity or to satisfy himself that no irregularity in fact exists. Denial of access to records, agreement as to audit scope, or limitation of fee cannot excuse the accountant from liability under such circumstances.

7. The accountant must use unequivocal language in his report.

8. The accountant is liable to the whole world for statements made by him in a professional capacity. He must prepare his report as though it were to be presented to unknown third persons, notwithstanding a promise that it will not be so employed.

9. The existence and possible effect of any limitation on the

character or extent of his audit, or of any important divergence from an accounting principle or canon of professional practice, must be clearly set forth in the accountant's report.

The Audit Basis

In its most general use, "audit" means any inspection, whether professional or lay, of accounting records or reports. When used by the public accountant, the word applies, in a more restricted and professional sense, to his activities in performing what is commonly referred to as an "annual" or "balance-sheet" examination. Similar general and restrictive meanings attach to the word "auditor," with the addition that in this book it refers to the accountant in charge of the field work required in an audit engagement.

Some years ago a great deal of attention was given to the classification of the work of the professional accountant. Types of audits were elaborately defined and attempts were made to distinguish purpose, scope, and result. Today these classifications fortunately have been forgotten; had they prevailed, it would have been necessary to lead the nonaccountant reader of financial statements through a technical auditing maze before he would have been able to understand the extent to which the accountant had subscribed to them. It is now recognized that a certain minimum performance by the professional accountant must underlie every group of financial statements to which he attaches his name; otherwise, the development of grades of dependability for financial statements would be required—a situation that would confuse everybody, including accountants. Early regulations and opinions of the Securities and Exchange Commission had the salutary effect of leading accountants back to the single audit standard, which means that if a certain audit objective has been reached, the accountant may express an opinion, qualified where necessary. If the accountant cannot attain that objective, he may express no opinion at all.

Before essaying a definition of what should constitute the audit objective, it is necessary further to explore the meaning of the term "annual" or "balance-sheet" audit: that type of audit which so largely occupies the professional accountant's time. Originally the term referred to the work of the accountant in his "verification" of a balance sheet only. When it became the practice to present in annual reports to stockholders an income statement along with the balance sheet and the auditor's "certificate," accountants began to include in the latter references to the income statement also; but for many years their auditing techniques underwent little change. Thus, as late as 1936, in the pamphlet *Examination of Financial Statements by Independent Public Account-*

ants, an official publication of the American Institute of Accountants, the income statement and its elements were accorded only passing mention.[1] But the recognition of the need for extending audit techniques beyond their traditional limits has steadily increased. Not only has an examination, even though limited, of various profit-and-loss aspects become standard practice, but the auditing process is pushing on still further to embrace any management policies affecting financial statements.

The "annual" or "balance-sheet" audit has thus proceeded far beyond its original bounds, though the latter term is still in common use. In time it may be expected that a simpler term, such as "audit," will be generally preferred. In this book, "annual audit" will be the term most frequently employed.

An annual audit may be defined as *an exploratory, critical review by a public accountant of the underlying internal controls and accounting records of a business enterprise, precedent to the expression of an opinion as to the propriety of its statements of financial condition and operating results.*

The words used in this definition were deliberately chosen as requiring no special technical interpretations; they have fairly specific and commonly understood meanings among persons having some knowledge of business operations. An auditor not only looks at the books of account; he must know what the policies of the business have been, how well under existing controls these policies have been carried out, and to what extent the accounts reflect them. That is to say, he regards the accounts—and the financial statements prepared from them—as being the effect produced by the application of such basic business and accounting principles as have been accepted by the management. A lack of strength in devising and establishing implementing policies or in putting policies into practical operation is of concern to him, for it may extend the scope of his inquiries beyond his original plan and lead to the discovery of irregularities of various sorts. All this is necessary before the auditor can give his opinion of the financial statements—his opinion of their ability to convey clearly the meaning of what they purport to stand for.

Chapter XIII is devoted to the "detailed audit," an essential part of the annual audit where internal controls are weak, but usually applied only at the weak spots. Its object is to get as far as possible into the verification of transactions at their source and

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[1] The term "*examination* of financial statements" appearing in the pamphlet title is little more than a euphemism designed for those who wish to indicate by indirection that the income statement as well as the balance sheet is being subjected to the audit process and that the work of the auditor commences with the completed product, the financial statements, rather than with the books of account.

their subsequent classification and into the verification of clerical accuracy.

A number of general features that attach to the ordinary audit should be understood at the outset. These features are:

1. The bulk of the auditor's work may be performed either before or after the close of the period that it covers. In many cases, "preliminary work" eases the seemingly inevitable "busy season" with which the public-accounting profession must contend, and at the same time the auditor may be able to correct practices that would be more difficult to alter after the books are closed. In larger organizations, where the standards of internal control are high, it is possible to complete most required tests *within* the period, for if the auditor can satisfy himself that transactions are being and continue to be competently compiled, his work at the year end can be reduced almost to a formality. In such cases the general audit objective remains unchanged. The audit methods that are described in Chapters V to XII are staggered over the year with varying degrees of emphasis, and a more intensified effort is directed along the lines described in Chapter IV.

2. Good internal controls not only lighten the work of the auditor; they make possible a better audit. Every public accountant is familiar with this truism. It is sometimes said that the detail that an audit involves varies inversely with the excellence of the internal controls. Not all public accountants have actually modified their procedures in accordance with this belief, however. A conscientious auditor may become immersed in detail that might in a large measure be eliminated by a more intimate knowledge of the workings of internal controls. In this book the audit procedures suggested are premised on the existence of adequate controls. Where the controls are inadequate, the auditor's examination must be extended in accordance with such procedures as those discussed in Chapter XIII. The auditor always seeks to persuade his client to refine internal controls so that, for one thing, examinations in succeeding years may be improved.

3. Examinations of accounts are, for the most part, dependent for their effectiveness on sampling or testing. From the meaning and accuracy of a number of entries in an account, the meaning and accuracy of the whole account are judged. When errors and other irregularities are discovered, a more thorough examination is required. Sampling skills are not easy to acquire. They cannot, for the most part, be based on the mathematics of statistics; the "universe" from which the accountant samples is too intricate and unstable, and it is generally impossible to determine relevant possibilities in advance. Parallels between business organizations

and between the habits of individuals who figure in the accounting process lead to many of the auditor's decisions as to the testing program he follows.

4. Except as they may be revealed by following ordinary procedures, fraud and other irregularities are not disclosed by an annual audit; even a detailed audit may not reveal certain types of fraud. It is now generally recognized by business management that the best safeguards against fraud and other possible losses are well-designed internal controls and that audits extensive enough to cover even the more common varieties are too costly and usually unnecessary. This does not mean that the auditor should not be on his guard against the possibility of such irregularities; in fact, he would be negligent in his work if he failed to pursue certain well-established audit procedures, noted in subsequent chapters, that are specifically aimed at uncovering a limited number of fraudulent practices. But the discovery of fraud is no longer a major object of the annual audit.

Permanence of Certified Financial Statements

When an auditor appends his name to a financial statement, several weeks or months have elapsed since the close of the period or the point of time that appears on the statement. More weeks or months will pass before the statement will have been reviewed by persons whose decisions and actions will be influenced by information it reveals. Years later, the statement may again be examined, this time by persons whose critical faculties have been sharpened by hindsight. It is important, therefore, that the auditor impart to the product of his art those objective qualities that will give it the greatest degree of intelligibility and continuing worth. This end is attained by—

1. *Following the best audit standards.*

Audit standards are reflected in textbooks on auditing and accounting, pronouncements issued from time to time by such regulatory bodies as the Securities and Exchange Commission, audit bulletins published irregularly by the American Institute of Accountants' Committee on Auditing Procedure, articles in current journals, court decisions dealing with derelictions of members of the profession, and last, but not least, the intangible and irresistible force of public opinion. However, the adoption of standards by a professional society is almost certain to be a formal recognition and justification of practices already being followed by the profession: practices that do not always reflect advances in the art or that are, at best, a compromise between the old and the new.

In the long run, the individual auditor has little to do with the shaping of these standards, but he must conform his practices to the best of them and even anticipate them if his vision be broad enough.

2. *Subscribing to a highly objective basis of reporting.*

Reporting expedients, designed to serve purely temporary purposes, are frequently suggested to the auditor by management. Many of them, when given effect, have been found to contribute to clarity and various other virtues the auditor hopes to see reflected in financial statements. They always deserve the auditor's careful consideration. When they obviously violate the accepted canons of the profession by giving wrong, distorted, or too little information to readers of financial statements, the auditor must insist on the observance of the more traditional standards of reporting. When these standards conflict, as they sometimes do, the auditor's position has never been an easy one.

Conflicting standards on net-worth accounts have often been the only justification behind the effort of less scrupulous business management to "make a showing." Demands may be made upon the auditor to recognize charges direct to surplus or surplus-reserve accounts, so that in years of moderate or low profits the income statement may show a larger return on the investment than would otherwise be the case. In prosperous years, provisions for "nonoperating" reserves in the income statement have the effect of lowering profits to a "normal" level. By being persuaded to adopt elastic standards for such accounts, the professional accountant unwittingly becomes a party to the creation and maintenance of equalization reserves and other practices that tend to misinform investors and others who rely on financial statements. Often the stated reason for such practices is that the annual income statement should reflect "earning power"—that is, more uniform profits—but every auditor should realize that "earning power" cannot be made sufficiently objective in character to eliminate the possibility of manipulatory practices. Furthermore, nonregularity in the flow of profits is an important factor in many enterprises, indicating the strength or weakness of management, the risk inherent in the business, and other conditions that may be of prime importance to investors and interpreters of financial statements. A far more objective and long-range criterion for the annual income statement is that it should reflect all revenues, gains, expenses, and losses recognized during the year, as has been repeatedly urged by the American Accounting Association and strongly hinted by the Securities and Exchange Commission.

3. *Encouraging the adoption of improved accounting standards.*

For a number of years the professional accountant has had as an integral part of his annual-audit procedures the review of his clients' accounting practices and internal controls and the consistency of their application from one period to another. Through persuasion and occasionally through disclosure of less desirable practices, he has been able in most cases materially to raise the level of accounting performance, and he will continue to do so as his own standards become more firmly rooted. The result has been a more secure base for his audit and a much greater probability of maintaining a secure base in the future.

4. *Acquiring an intimate knowledge of business controls.*

A natural outgrowth of the emphasis on internal controls has been the realization by both professional accountants and business executives that these controls commence with top management, extend throughout the organization, and involve many matters that have heretofore been regarded as being within the management realm. It is now recognized that accounting does and should reflect management policy and that the auditor's familiarity with this field must be substantially greater than it has been in the past. A careful weighing of these policies at the time the financial statements are being prepared may affect the style and content of the presentation, and in any event will give the final product an authentic and lasting quality it would not otherwise possess.

CHAPTER II

The Mechanics of Auditing

"Working papers" is the term used by public accountants to designate the file of analyses, summaries, comments, and correspondence that is built up during the course of an audit engagement. It is their record of work done and it supports their findings. A new file is prepared with each succeeding audit. Files of working papers are carefully indexed and preserved for many years. Working papers are the public accountant's property and their contents may not be revealed to others without the consent of the client.[1] An illustrative set of working papers appears in a companion volume to this bcok.

Individual working papers take many forms. They range from elaborate account summaries to brief narratives. In recurrent annual-audit engagements, the form and content of working papers may closely resemble the previous year's. This habit is an easy one for auditors to fall into and it is unobjectionable if the previous year's papers are of a high quality. However, many working papers can be improved upon and the events of each new year may demand a different emphasis. Experienced auditors find it wise to vary their approach to the same problem from year to year; they often recast, condense, add to, or omit altogether what was done during previous audits. Material variations in working papers are discussed with the auditor's principal before they are put into effect, so that matters of firm policy may not be overlooked.

Working-Paper Standards

Public-accounting firms adopt working-paper standards in order to secure uniformity (for ease in current and future reviews) and to insure that the firm's audit procedures have been followed. Necessarily, field work must be assigned to professional employees whose backgrounds of experience and personal preferences may differ widely. Yet a fair degree of similarity is found in the audit working papers of all public-accounting firms, and little difficulty

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[1] A decision, often cited, supporting this point of view may be found in *Ipswich Mills v. Dillon,* 260 Mass. Rep. 453 (1927).

is ordinarily encountered by a newly employed auditor whose professional habits have been acquired elsewhere.

Among the standards in current use are the following:

1. Everything appearing in the working papers should have a purpose related to the assignment, and the purpose should be clear not only to the auditor but to others who may have occasion to review the papers when the auditor is not present.

2. No questions, question marks, open points, incomplete notes, or other indications of unfinished work should remain on any working paper. Reasons should appear for "passed" items.

3. An "agenda" worksheet (also called "point list") should be employed for noting items of work to be done that cannot be completed by following the usual sequence of procedures. This sheet serves simply as a reminder and is added to whenever necessary, with cross references to the related working paper. When the item of work is completed, a note is made of the work done or reference is made to the worksheet on which the information appears. Before the report is released to the client, the agenda worksheet is again reviewed in order to make sure that each item has been disposed of.

4. Adjustments and reclassifications made by the auditor should be spread on the working papers so that working-paper references and totals will be in agreement with the adjusted trial balance.

5. At the time the annual audit program is being drafted, it is usually determined by the auditor and his principal what working papers the client's staff will be asked to prepare. These papers may include such items as trial balances and account analyses. The practice of asking for the assistance of the client's clerical staff on such matters reduces audit expense and enables the auditor to concentrate on other problems, but the auditor must not rely upon any figures or other information contained in such papers until they have been carefully tested.

6. Sources of figures and other information appearing in working papers should always be indicated. The reader should note the methods followed in the Illustrative Audit.

7. Each worksheet, or top worksheet for a group of worksheets, should contain a narrative of what the auditor or his assistant actually did. The audit program, described in the next chapter, indicates the work *planned;* the working-paper narrative, the work *done.* Usually appearing at the bottom of the worksheet, the narrative should not repeat, in fact should avoid, the language of the audit program or other instruction, even where the program or instruction has been fully carried out. The narrative need follow no particular pattern; it should be worded informally; it should be brief but factual, and understandable by and convincing to

others; and it should be prepared after the work to which it refers has been completed.

8. The title lines at the top of each working paper should show the name of the client, the period covered by the audit, and a clear indication of what follows. In the upper right-hand corner, the person who has prepared the working paper should insert his initials and the date that section of the work was completed.

9. Cross-referencing should be as complete as possible, with distinctive check-marks for each type of reference.

The most common size of working paper is 8½″ x 14″ for single sheets and 17″ x 14″ for double sheets, with 7 and 14 money columns, respectively, each 1⅛″ wide. Horizontal rulings are ¼″ apart, with every third or fifth line somewhat more heavily inked in order to make it easier for the eye to follow across the related items.

Indexing Working Papers

As a rule, working papers, prepared annually, are uniformly indexed within each public-accounting firm. Many different schemes are in use, but the following is probably as characteristic as any:

Cover—containing name of client, period covered, names of auditor and assistants, and date of audit report

Analyses and comments on accounts

1	Working trial balance	P	Accrued liabilities
2	Adjusting journal entries	Q	Federal income tax
3	Reclassification entries	R	Contingent liabilities
4	Agenda	S	Long-term debt
A	Cash	T	Reserves
B	Marketable securities	U	Capital Stock
C	Receivables	V	Surplus
D	Inventories		
F	Long-term investments	AA	Sales
H	Fixed assets	BB	Cost of sales
J	Depreciation reserves	CC	Manufacturing expense
K	Intangibles	DD	Selling expense
L	Deferred charges	EE	General and administrative expense
N	Notes payable		
O	Accounts payable	FF	Other income
		GG	Other expense

Minutes
Notes on conferences
Engagement memorandum
Audit program

The numbers and letters may be followed by a dash and a separate number series for the individual worksheet. Thus, in the Illustrative Audit, A-1 is a cash summary, A-2 and A-3 are bank accounts, and so on. The working trial balance constitutes an index for the great bulk of the working papers.

Working Trial Balance

The working trial balance serves as the auditor's top control. It is prepared preferably in financial-statement order, regardless of the ledger sequence. Trial-balance schedules are often made up on the auditor's working paper by the client's clerical staff. Spaces should be left where experience has shown that adjustments may be required. The principal features incorporated in a working trial balance like the one accompanying the Illustrative Audit are these:

1. Spaces may be provided on the left margin for (a) working-paper number and (b) ledger-account number.
2. Balances of the accounts at the beginning of the year, taken from the books, serve as a basis of comparison for current-year accounts. They are compared with last year's papers to make sure that the books were conformed to the auditor's report. They may also have the effect of calling attention to changes of classification during the year.
3. Separate sheets are provided for assets, liabilities, income, and expense, thus eliminating the need for extra debit and credit columns.
4. Adjusting journal entries are usually numbered serially, made up in conventional form as the decisions to make them are reached, and posted to the related worksheet and to the working trial balance. Care must be taken to make sure that the accounts adjusted are correctly named and numbered and that explanations are full and complete, so that at the conclusion of the audit a typed copy of the adjustments (omitting references to working papers) without further editing may be presented to the client for formal entry on the records.
5. The "after adjustment" column should reflect the correct amounts of the ledger accounts as they are ultimately to appear on the books.
6. A "reclassifications" column and a "report" column usually prove to be time savers for most auditors. Formal reclassification entries are prepared at the conclusion of the audit in order to conform this year's statements with the financial-statement sequence followed last year. Each year, however, the propriety of such entries should be re-examined. When separation lines are drawn between account groups that are to be combined for report pur-

poses, the sources of each report figure are apparent. If, for some reason, the accounts cannot be arranged in financial-statement sequence in the working trial balance, the auditor may have to employ a "grouping sheet" in which the balances of individual accounts, as adjusted, are added together.

7. In the "remarks" column are inserted comments that relate to the financial statements. Where the balance of an account has remained unchanged during the year, the letters "NC," followed by the page number of the permanent file, may be put in the remarks column and no analysis need appear in the current year's working papers.

A working trial balance should be provided for a "private ledger" or any other separately maintained collection of accounts, and adjusting entries should be so designed as to preserve whatever self-balancing features are maintained in these ledgers.

Permanent File

For every repeating audit engagement, a permanent file should be carefully built up and preserved. The purpose of the permanent file is threefold: from it can be obtained, by persons unfamiliar with the client's business, a quick picture of the financial history of the business; it provides a ready reference for and a brief summary of recurring or continuing items, thus eliminating repeated reviews of lengthy documents and searches among old working papers; and it serves to eliminate the preparation, year after year, of new working papers covering items showing few or no changes. If carefully bound, the permanent file may be carried to the job along with the working papers of the period immediately preceding. To it will be added whatever recent changes have occurred in the items that it contains and, when the audit has been completed, it will be reviewed by the auditor's principal, along with the current working papers, as the record of work done. Even though the "quick picture" afforded by the permanent file is of advantage only to succeeding years' auditors, it serves a most useful purpose for them; it refreshes their memories or, for auditors newly assigned, it gives them a readily assimilable introduction to the client's affairs. Every conscientious auditor takes professional pride in adding accuracy and useful information to the permanent file for the benefit of next year's field staff.

Summaries of analyses or, where practicable, the analyses themselves are provided for the more important accounts, particularly for such accounts as:

Long-term investments	Long-term liabilities
Land	Reserves

Buildings
Machinery
Furniture and fixtures
Reserves for depreciation
Intangibles
Long-term deferred charges, such as bond-discount-amortization schedule
Capital stock
Paid-in surplus
Earned surplus, including dividend record
Sales by products
Cost of sales by products

Where the current audit work required on any of the above items is minor, the detail added to the record in the permanent file need not again appear in the current working papers, provided reference is made on the working trial balance to the page number of the permanent file.

Once an account summary has been filled in, it serves as a basis for each succeeding year's review. Changes are recorded on the summary until space for further amendment has been exhausted. At that time a new page is prepared on which matters of continuing interest are carefully transcribed. The superseded page is then placed in a "transfer" file or filed with the current year's papers. As a rule, statement and account summaries should never be removed from the permanent file, otherwise their value as bases of comparison will be lost. To reduce the bulk of account summaries, the space devoted to changes should be confined to the minimum permitted by the need for clarity.

Other information and documents or briefs thereof that will increase the usefulness of the permanent file include:

History of business
Organization chart
Plant and office layouts
Articles of incorporation
Bylaws
Notes on internal controls
Accounting policies
Manual of accounts
Office memoranda relating to accounting
Inventory procedures
Bonus and profit-sharing plans
Pension plans
Labor agreements
Stock and bond samples or photostats
Minutes of stockholders
Minutes of directors
Minutes of executive committee
Patent-litigation details
Leases
Long-term contracts
Guarantee agreements

Bulky long-term documents, such as trust indentures or contracts, should be placed in a "Permanent-File Appendix." If briefs are prepared for the permanent file proper, the appendix need not accompany the auditor in the field.

Abstracts of Minutes

During an early stage in the audit, often as part of the preliminary examination, the auditor reads the corporate minutes:

that is, the minutes of stockholders, directors, and the executive and other committees subordinate to the directors. Many kinds of decisions, affecting any part or all of the organization, will be found in resolutions or in less formal actions of these groups. A good deal of time will be saved if arrangements can be made with the company's secretary whereby an extra copy of each set of minutes is given to the auditor. The extra copy will be a carbon copy in the case of smaller organizations where it is not the custom to supply copies of minutes to members of the groups named above, and dittoed or mimeographed copies where the reverse is true. When copies are given to the auditor, a statement over the secretary's signature, similar to the form shown below, should indicate their completeness. If copies cannot be given to the auditor, he must read the minute books themselves and make such abstracts as are necessary. In addition, he must procure from the company's secretary a statement indicating that the minute books examined are complete and up-to-date.

Messrs. Hyatt, Paterson & Co.,
960 Hudson Bldg.,
Chicago, Ill.

Dear Sirs:

I have furnished you with copies of the minutes of the meetings of the stockholders, board of directors, and executive committee. These copies are the complete, official minutes for the period from ________________ to ________________ [the dates should preferably be the final field-work dates of last year's and this year's audit], as follows:

Meeting of	Date of meeting

Very truly yours,

____
(name of company)

____
(signature of secretary)

The minutes or abstracts from the minutes may be placed in the permanent file in their entirety, or, even better, brief abstracts of items having effect beyond the current year may be placed in the permanent file, the minutes or longer abstracts remaining with the current working papers.

Among the points of importance to the auditor that are to be found in the minutes are the following:

- Officers elected
- Compensation of officers and executives
- Profit-sharing, bonus, and pension plans
- Dividends declared
- Changes in capital stock and funded debt
- Designation of depositories
- Contracts with employees
- Settlements of litigation and disputes
- Purchase and sale of securities and other assets
- Authorization of construction contracts
- Surety bonds required

Analysis of Accounts

At the conclusions of Chapters V-XII appear outlines of audit procedures commonly regarded by public accountants as minimum procedures in the conduct of their examinations. The minimum procedures apply where the internal controls are found to be satisfactory. Weaknesses in internal controls at any one point require, as a rule, a more extensive audit along the lines described in Chapter XIII.

Each of the audit procedures begins with a verb of instruction. These verbs have a generally recognized significance, discussed in the following sections of this chapter, but it must not be supposed that any of them has an exact and inflexible definition. To some extent they are interchangeable. Wherever they are used, their more precise application may be determined from the context.

To *analyze* an account is to set forth the details or summary of the account, obtained, where necessary, by reference to sources and accompanied by explanations of major items and cross-referenced reconciliations with related accounts. Numerous examples of account analyses are given in the working papers of the Illustrative Audit. The analysis will usually include the following elements:

Balance at beginning of audit period. This relates, of course, to balance-sheet accounts. The balance found in the books is always compared with the balance appearing in the previous working papers.

Transactions during the year. For most purposes, only a summary need appear on the working paper in the form of the total of each class of debits and each class of credits, each accompanied by a full explanation of its source and meaning.

Adjustments prepared by the auditor. These may be included in each summary-of-transactions figure or may be appended at the end of the analysis.

Balance at the end of the audit period, before and after adjustment. The closing balance is compared with the corresponding

item on the working trial balance before and after adjustment.

This type of analysis may be observed in the summary of fixed assets and reserves for depreciation appearing in the Illustrative Audit problem. The procedure on the summary of asset costs (H-1) was as follows: columns 1 and 6 were filled in from the books and the amounts or totals were compared with the working trial balance; analyses were made of additions and retirements (schedules H-2 and H-3), which incorporated the adjustments determined by the auditor to be necessary, thus leading to the amounts transferred to columns 5, 4, 2, and 3, in the order given. The comments on the lower half of Schedule H-1 were filled in by the auditor when his figure analysis had been completed and schedules H-2 and H-3 had been prepared.

Another type of analysis is that which sets forth on the working paper some sort of detail of the balance making up an account on the audit date. This procedure is illustrated in such schedules as N-1 and O-1. The latter schedule consists primarily of an adding-machine tape prepared by the auditor from the open items in the vouchers-payable register. An analysis of the accounts-payable account covering the period of the audit is not often necessary. The summary at the bottom of the schedule shows the unadjusted, adjusted, and reclassified totals, respectively, following the determination of the adjusting and reclassifying entries. The explanation for each of these entries could have been shown in the accounts-payable schedule, but in most cases an adequate explanation attaching to the entries themselves is sufficient for the auditor's record.

Testing

To *test* means to determine accuracy by selecting and studying representative items or samples from a given collection or class of transactions or other data. In choosing samples, the auditor seeks not only quantitative information (e.g., dollars, number of units) but qualitative information as well (e.g., correctness of classifications, conformity to prescribed procedures). Conclusions as to accuracy are nearly always dependent on both types of information. Transactions having the same description may constitute the bulk of the dollar amount of an account and an examination of a small portion of these transactions may give assurance on all of the same type, though it will prove nothing with respect to transactions making up the remainder of the account. Qualitative tests must be applied to this lesser fraction, as it not infrequently happens that where numerous small components make up a comparatively unimportant total, employees, as well as the procedures under which they operate, devote little attention to safe-

guards, and errors are therefore common. A fair sampling of each class of smaller transactions is essential to every testing operation.

The samples with which the auditor deals are of four principal varieties: *arithmetic*—accuracy of extensions and footings, agreement of entries with postings, or of postings with entries, of checks with vouchers; *classificational*—whether transactions have been carried to the proper accounts in accordance with the classificational design and whether any material changes have taken place during the year or as compared with the previous year; *procedural*—whether the handling of the client's everyday business has followed predetermined outlines or, if not, whether required approvals have been secured, and whether the procedures reflect generally accepted accounting principles; and *internal-control*—whether accounting and management methods actually employed provide adequate safeguards against frauds and other irregularities and against poor business standards, or, on the other hand, whether they are so elaborate and cumbersome that the accounting and reporting process has been slowed down at any point.

Part of the testing process may consist of a complete coverage of all transactions for a limited period. This procedure is of value in situations with which the auditor may be relatively unfamiliar or in which new procedures or a new type of business is involved. By going through a brief, detailed examination, the auditor is often in a better position to do a more intelligent job for the balance of the period selected for testing.

Occasionally, testing will disclose that the same type of error has been made repeatedly by the client's staff or that some other deep-seated fault will require a material revision of the records. This condition may call for a suggestion to the client that the client's own controller or some person designated by him make a detailed review of the difficulty in order to establish a proper basis for the accounts. To conform to professional standards, the auditor, even though the client is willing to extend the scope of his services, must not perform bookkeeping work except under conditions approved by his principal.

Scanning

To *scan* means to look over rapidly but skillfully in order to discover the more general, qualitative aspects of a procedure, account classification, or account content. Scanning accounts calls for the auditor's best judgment. It is something that cannot be delegated to junior staff members because a good job of scanning can be done only by a person who possesses a background accumulated over many years of experience in auditing the accounts of a variety

of business enterprises. It means looking at individual ledger accounts briefly and expertly, understanding their meaning, observing the nature of postings and testing their sources, but making no working-paper notations or item investigations except for unusual items. The skill of the auditor is well tested by his ability to recognize unusual items and, further, by what he does following their discovery. Where internal controls are good, his investigation of such items will be less rigorous than where controls have not been well maintained. But he will always be on the lookout and satisfy himself as to causes for:

Errors of classification
Changes of classification
Variations, between months *and* between years, in totals, the number of transactions, and the size of individual transactions
Entries from uncommon sources
Material adjustments
Debit entries in income accounts and credit entries in expense accounts
Faulty explanations accompanying postings

Scanning is an adequate substitute for what would otherwise be detailed and pointless analyses of the ordinary run of income and expense accounts.

Other Procedural Instructions

Among other terms and their meanings employed in the audit instructions of Chapters V-XII are the following:

Review: to study critically a procedure or series of transactions.

Compare: to establish the correspondence or similarity of differently located items.

Trace: to ascertain whether an item has been disposed of in accordance with source indications.

Investigate: to search for and relate underlying causes.

Account for: to obtain an accurate breakdown and explanation of an amount expended.

Examine: to probe into records, under predetermined standards and procedures, for the purpose of arriving at opinions of accuracy, propriety, sufficiency, and the like.

Verify: to confirm the accuracy of, by competent examination. Use of the verb "check" should be avoided because of its varied, uncertain meanings.

The above ten definitions are couched in language meant to be nontechnical in character. The audit activities that they suggest are not mutually exclusive, for the meanings of these words overlap. Thus, when an account is "examined"—by observing a prescribed procedure—the visible result at the end of the examination

may be an account analysis or a series of scanning notes, as most auditing work involves some sort of analysis or scanning. The choice of method is frequently left to the judgment of the auditor after he arrives in the field. Again, when a posting is "verified" by "tracing" it back to the journal or voucher from which it originated, the auditor's act may be a part of the procedure he is following in "analyzing" an account.

Further Meanings Underlying Instructions

Inherent in each audit instruction is the implication of a professional intelligence on the part of the auditor that will give the product of his work the stamp of competence, for in following out an instruction the auditor is always expected by his principal to—

1. Have well in hand the features of the client's internal controls relating to each item examined.
2. Be able to detect and deal with the client's employees on departures from established internal controls.
3. Determine what additional audit steps, such as those contemplated in a detailed audit, are necessary to offset flaws in internal controls.
4. Be alert for irregularities, inconsistencies, irrelevancies, bad arithmetic, insufficient explanations, and alterations.
5. Depend, as infrequently as possible, on the client's written procedures and on oral statements made by the client's staff; rely rather on first-hand investigation.
6. Regard formal audit procedures and any specific programs or instructions as general guides, subject to supplementary extensions, within such time or other limits as may have been imposed, wherever, in the judgment of the auditor, the following of any prescribed procedure has not yielded or will not yield an adequate answer.
7. Sense what is important and distinguish between major items that require a working-paper record, the preparation of an adjusting journal entry, or other action on his part, and minor items that may be safely ignored or may be referred to the client's staff without further action. (The determination of items as minor may be left to the auditor's judgment or may come within a predetermined percentage or amount.)
8. Dispose of items well within his field of knowledge and his jurisdiction and refer to his principal, with suggestions for action, matters with which he may be less familiar or that may require negotiation by his principal with the client.
9. Conduct himself professionally; follow and persuade others to observe the best accounting and auditing standards; and sense the practical effect of permitting deviations from such standards.

10. Detect and weigh carefully any change during the period in accounting procedures that might alter present or future operating results or financial position, determine its current effect on the accounts, and, where its importance warrants, discuss with his principal its possible disclosure in the report.

11. Set forth in his current working papers a concise narrative of the work he has done on each item in the audit program, and, where an adjustment or disclosure has been waived or where a disclosure in the report is deemed necessary, include full reasons therefor in the narrative.

In the audit instructions, the clue does not always appear for disposing of differences, oddities, or irregularities that may be revealed by following out the instructions. A cataloguing of the variables that the auditor may discover would be impossible. The experienced auditor will be able to come to practical conclusions on most of them; some of them he will dismiss as having no importance; others he will discuss with the management, as the result of which no action is taken, future procedures are changed, or an adjusting journal entry is made; still others he will refer to his principal. The primary purpose of any audit procedure is to lead the auditor to opinions of correctness or incorrectness of the accounts as he finds them. Corrections, if important enough to warrant an adjusting entry, are made in the light of what the auditor conceives good accounting to be.

CHAPTER III

Planning the Audit

In a public-accounting firm the personnel consists of various employee classes that may be summarized as follows:

Titles	*Simplified titles*
Senior partners Junior partners Managers or supervisors	Principals
Accountants-in-charge Seniors	Auditors
Semiseniors Juniors	Assistants
Office assistants or proofreaders Clerks and stenographers	Office staff

The simpler classification, followed in this book, indicates the levels at which audit work is planned and carried out. It is in use among a number of accounting firms for the same reason. The firm's policies and procedures are determined by the partners and are made known to employees by memoranda, manuals, conferences, training courses, and individual instruction.

Practices vary among public-accounting firms, but the differences are not as great as they were ten years ago. Whether it will be possible to reach a greater uniformity depends on the farsightedness of professional societies in their anticipation of new problems and on the willingness of the members of the profession to conform to a common pattern. Up to now there has been a material lag between the occurrence of phenomena that require policy decisions by individual firms and the adoption of standards by a professional society. Consequently, a standard tends not to be readily accepted unless it happens to coincide with policies already in current use. Another tendency, which follows partly as a corollary, is that professional committees are often constrained to give the stamp of approval to existing practices and events that

have already occurred, without giving adequate weight to the effect of their decisions on other practices. In general, however, the progress of accountants in improving their professional standards and in recognizing their social obligations has continued for many years, and it may be expected that the impetus will extend at least into the immediate future.

How Auditors Are Chosen

Public accountants are, as a rule, chosen by management. The decision may take the form of a direct appointment by the executive head of a business or of an appointment emanating from the board of directors following a recommendation from the executive head. In some cases, a committee of nonofficer board members nominates a firm of public accountants and the stockholders at their annual meeting approve the choice or select a firm independently. This method of selection does not, of course, insure that the stockholders are acting independently in choosing their auditors. As is so often the case in American business, the great majority of stockholders (and boards of directors) may follow uncritically the recommendations of management. But once the selection of the public accountant has been made by the stockholders, the accountant's independence of factions within the business tends to be increased, especially in larger enterprises where stockholders' meetings are reported on by financial writers; for if a change of accountants is proposed to the stockholders, reasons for the change will probably be made public. If the management's only objection to the accountant is his assertion of independence, the stockholders, even though complaisant on most matters, will in all probability be compelled to align themselves on the side of the accountant.

Regardless of how he is appointed, the accountant may be asked to confer from time to time with the board audit committee, and to address his report to the board. The continued development of these relationships will increase the accountant's feeling of independence as well as his independence in fact, and will enhance the value of his findings to management and investor alike. Where accountants have been chosen by the stockholders, they customarily attend stockholders' meetings in order to answer questions put to them on matters pertaining to their reports or coming within the field of general financial policies and problems.

Arrangements with Client

Before concluding an agreement to perform an audit, the public accountant and his client come to a common understanding on the nature of the audit and the audit report, the time of performance,

the date the report is to be delivered, and the accountant's compensation. A proposal may be submitted at the client's request, addressed to the president or other officer, or to the board of directors, embodying these details. If the proposal is approved, one copy bearing the client's endorsement is customarily returned and is regarded as a contract. It is more usual, however, not to go through the formality of a proposal and acceptance but simply to address a letter of arrangement to the client, confirming an oral agreement and setting forth the items mentioned. Many accountants do not prepare even a confirming letter, preferring to keep their relations with clients on a wholly informal basis.

The usual type of audit is generally referred to in arrangement memoranda as an "annual audit," a "balance-sheet audit," or an "examination of the balance sheet [at a given date] and the income statement [for a specified period]." Reference may be made to a detailed audit for a limited portion of the period or to any special work that will be performed at the same time.

Audit reports, described in Chapter XV, may be in any one of a number of styles. The most common form, at least for larger corporations, is the brief two-paragraph "certificate" illustrated on page 208. For smaller or closely held corporations, or for partnerships, trusts, private investment concerns, proprietorships, and the like, a more extended form, containing no "certificate," may be followed.

Despite agitation for a more widespread adoption by business of the "natural business year," as much as two-thirds of the average public accountant's regular annual audit engagements are crowded into the first few months of each calendar year. Even where an audit is made promptly after the fiscal period has ended, a month or two is generally required before the audit report can be released. In the interest of prompt reporting—a virtue to which every accountant subscribes—a number of accountants have recently been extending the coverage of their preliminary work and shortening the time required for the post-year-end work. The same tests are made, but they are applied *during* the year rather than after the year ends. This newer procedure relies more heavily on a knowledge of how the business and the business records have been operating, a knowledge gained by observations at the time transactions are taking place. Some danger exists if auditors permit themselves to be drawn into discussions of operating problems before transactions are concluded; they may thus become preauditors rather than postauditors and adopt an operating rather than the typical audit point of view. The auditor's program and the supervision given him by his principal must be such as to insure that he is not in effect absorbed by the client's

organization. Rotation during the year of auditors assigned to such work may aid in maintaining audit independence.

Compensation of public accountants may be on a flat-fee or per-diem basis plus traveling expenses, if any, or a per-diem basis plus expenses with a maximum total fee. Naturally, the accountant prefers per-diem arrangements in order that unforeseen situations, which may arise in the midst of any audit engagement, may be adequately explored. With a top limit on his fee, he may seek to have it raised when confronted with unexpected problems, or run the risk of incurring a loss. Average per-diem rates for principals range from $50 to $100; for auditors from $25 to $50; for assistants from $10 to $25; for office staff from $5 to $10. In each case, the per-diem rate contemplates a seven- or eight-hour day with overtime at the same rate.

Audit Manual

Many public-accounting firms have prepared manuals for the guidance of their staffs in audit planning and performance. These manuals lay the background for the annual audit and for the conduct of the auditor in the field. They outline standards of accounting and internal controls, give particulars of the preparation of working papers, discuss valuation problems, and provide guides for audit procedures and for the construction of reports.

Opinions differ on the value of applying minimum standards or ready-made procedures to every annual-audit engagement. Such a program has been adopted by a number of public-accounting firms and works well when carefully controlled. But there is always the danger that minimum procedures may become maximum procedures and that the auditor's initiative may be cramped by too much uniformity. Besides, books of account and internal controls differ so widely that no single set of procedures can be regarded as the precise minimum required by good auditing practice for any one engagement. Nevertheless, in the opinion of the author, minimum standards deserve an important place in every public-accounting organization as well as in the general concept of auditing itself. In fact, minimum standards of procedure may be looked upon as an enlargement of the auditing definition, as a practical application of what would otherwise remain an abstraction. It is true that a given set of standards, no matter how carefully devised, invariably refers to an *average* situation—a situation that no one actually encounters. But if the accountant keeps that fact in mind, he will have little difficulty in adapting the accepted standards to his immediate needs. For each engagement he must build up a set of equivalent standards, for which the ideal standards will serve as an admirable base.

Audit Memorandum

Before auditors commence their field work, it is customary to prepare a memorandum containing useful information regarding the client and details of the agreement as to when the work will start and other conditions relating to the audit. This memorandum should be the work of a principal of the public-accounting firm and should be put together at about the time the audit is arranged for. It will be fairly extensive if the audit is being made for the first time, and possibly quite brief if a similar audit has been made before. The purpose of the audit memorandum is to make preliminary observations and understandings a matter of record, particularly for the benefit of the auditor who will be responsible for the field work. It provides him with an introduction to the organization and its personnel and may disclose a number of specific problems that will be encountered.

In most cases, the audit memorandum is likely to be little more than a record of conversations with the client's officers. Among the points it may profitably contain, in the event of a first audit, are these:

Ownership and control; reorganizations in recent years
A sketchy history of net-worth accounts
Principal kinds of products
Nature of the market in which the products are sold
Price conditions and trend of sales
Advertising methods
Location of plants and offices
Character and adequacy of manufacturing facilities
Sources of raw materials and trends in prices
Names and interrelation of principal officers
Responsibility of controller
Books of account, nature of and where kept
Who gets controller's monthly reports and how they are used
How this year differed from last year: new products, new equipment, changes in cost, financial problems
How next year will differ from this year: changes in production, plant, costs, management
Purpose of investments
Purpose of contingency and similar reserves
Subsidiary companies and how they are operated and controlled
Special problems raised by management: opinions of internal controls, accounting policies, costing methods, promptness and accuracy of internal reporting
Tax returns: preparation or review
Preparation of government reports

Documents like the following, which the principal may bring back from his preliminary survey, will help materially in building up the audit program:

Manual of organization
Functional and organizational charts (an informal diagram of relationships may prove to be even more informative)
Recent annual reports to stockholders, notices of annual meetings, and proxy solicitations
Recent monthly financial statements and reports issued by controller

Once information of the type described above has been put into an audit memorandum, there is no need for repeating the process in succeeding years. Subsequent annual-audit memoranda may be limited to changes and new problems.

An audit memorandum should be regarded as primarily informative in character. As it may be a report of conversations, it may contain factual inaccuracies and is never intended as a substitute for original investigation by the auditor.

Often the annual-audit memorandum is supplemented by a "memorandum of engagement," a single-page printed form, a copy of which is furnished the auditor by his principal and is included in his working papers. Following is an example:

HYATT, PATERSON & COMPANY
Certified Public Accountants

Prepared by *AHP* Date *8-1-46*

Memorandum of Engagement Assigned to *J S Burke* Date *8-6-46*

Client	*F. L. Barnes & Co.*
Address	*1490 Edison Bldg., Chicago*
Telephone	*Central 5846*
Conference	
Letter	*July 12, 1946*
Report to be addressed to	*Board of Directors*
Report due	*March 5, 1947*
Account to be charged	*F. L. Barnes & Co.*
Fee basis	*$75, $40, $20, $10, with top of $1,500*
Location of books	*as above*
Nature of business	*manufacturer wood specialties*
Audit coverage	*annual audit, calendar year 1946*
Preliminary work	*October*
Personnel *1-1*	for *3 weeks*
Special instructions	

Audit Program

An audit program bears the same relation to a forthcoming audit as a budget to future operations. It is the plan of work to be done

and a connecting link between principal and auditor. It is made up in the public accountant's office before the field work commences. In the field it serves as a directive and guide against which actual performance is ultimately compared. Like any other type of planning well conceived, a carefully drawn and executed audit program gives order, point, and coherence to the audit undertaking.

At the end of each of Chapters V to XII is a series of audit instructions that, if all of them were put together, would constitute an audit program. In practice, the instructions are abbreviated or amplified at the discretion of the principal, depending on a number of factors. Occasionally, an auditor whose professional attainments have been well tested is given an assignment by his principal with virtually no instructions. This might occur in a first audit where the principal has been unable to make a preliminary survey along the lines indicated above. Some accounting firms prepare an audit program only for their larger assignments. In other instances, audit instructions such as those contained in this book might be too brief and would require considerable amplification in order to make them workable in the hands, for example, of assistants who cannot be under the daily supervision of the auditor—a situation that arises when an assistant is sent to a branch office or another plant. Detailed instructions may also be required where weaknesses in internal controls are discovered or are known to exist, where the records are unusually complicated, or where for other reasons the principal desires to have out-of-the-ordinary tests applied.

It has been the author's consistent experience that some form of written audit program is essential to every engagement. The program should indicate in broad strokes the work to be done, the time allotted to each section of the audit, and, as the various stages of the work are completed, the time actually consumed. The time estimate for a first audit will necessarily be tentative, but it can be based on the firm's experience in other engagements, often with a fair degree of accuracy. When supplemented by a weekly report from the field on work done, the principal is able to follow the progress of the audit, watch for overruns, give assistance to the auditor on the revision of his program, determine when his (the principal's) presence is needed on particular problems or to wind up the engagement, estimate the time at which the auditor and his assistants will be available for other work, and have at hand a good guide for next year's audit program.

The time at which next year's audit program should be prepared is at the conclusion of this year's audit. Deficiencies in this year's audit performance, weaknesses disclosed in principles and pro-

cedures followed by the client, needed follow-ups on transactions not yet completed—all these are matters that are fresh in the minds of both principal and auditor when the current year's work is ended and that all too often are imperfectly recorded in the working papers. Some of them may require action early in the new fiscal year. Much time is lost and important points may be overlooked when principal and auditor leave the drafting of the program to a later month.

One method of making up an audit program is to prepare a list of the items of work to be done and the estimated time required, with blank spaces for the name or initials of the staff member to whom the work was assigned in the field and for the hours actually spent. If the cash program is to be the "minimum" procedure suggested in Chapter VI, the list of work items might appear thus:

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Certified Public Accountants

Client *F. L. Barnes & Co.*

Audit Program Detail — Period *Year ended December 31, 1946*

Standard Program	Detail of work	Assigned to	Estimate of hours		Actual hours
	Cash—				
1	Bank letters (Jan. 9 cutoff)		—	—	
2	Cutoff reconciliation (2)		1	10	
3	Year-end items		—	1	
4	Year-end reconciliation (2)		1	10	
5	Checks on hand, recorded as issued		—	1	
6	Receipts and deposits, −5 and +5		2	—	
7	Transfers, −5 and +5		1	1	
8	Petty-cash review		—	1	
9	Restrictions on balances		—	—	
	Marketable securities—				
	Etc.				

The totals of each section of the work list may be assembled on a summary sheet having the form appearing on page 34.

In both forms illustrated, it is assumed that two grades of hours are to be billed to the client, thus requiring separate accumulations for each grade. The first half of each hour-column contains the auditor's (senior's) time, and the second half the time of his assistants. No estimated or actual time need be shown, as a rule, for fractional hours. Thus, the work detail entitled "Bank letters" is estimated here as requiring less than an hour. Space is provided on the summary sheet for "unallocated field time"—time

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Client *F. L. Barnes & Co.*

Audit Program Summary Period *Year ended December 31, 1946*

Index	Nature of work	Estimate of hours		Actual hours		Comments
1	Working trial balance	4	4	6	5	
A	Cash	5	24	2	35	
B	Marketable securities	1	10	1	9	
C	Receivables	22	48	18	40	
FF	Other income	1	6	2	4	
GG	Other expense	8	—	2	5	
	Minutes	8	—	10	—	
	Financial statements	16	8	12	7	
	Report	16	16	22	14	
	Unallocated field time	16	8	15	3	
	Office time	8	8	5	—	
	Total hours	168	224	152	231	

spent on conferences and on other work that may not be worth while classifying. Allowance must be made, of course, for "office" time—that is, work on putting working papers together, bringing up the permanent file, and reviewing the papers and report with the principal.

The work titles on the "Audit Program Detail" illustrated above are abbreviated as much as possible. Where instructions must be elaborated by the principal, they may be included as a part of the audit memorandum.

When the auditor assigns any item of the program to an assistant, he will explain in detail the character of the work to be done and the nature of the working papers that will constitute the end product. The instruction will be given orally or in writing as the occasion may demand, this being left to the auditor. Time estimates shown on the program detail should not, as a rule, be communicated to the auditor's assistants, but he should make clear to them the details of what they are to do and how they are to do it and should provide adequate supervision while their work is in progress. When the assignment is completed, the working papers are reviewed by the auditor and put into final form. Both the

auditor and his assistants will probably keep on worksheets a record of their time, program items running one way and dates the other.

Schedules Prepared by Client

Mentioned in Chapter II was the common practice of asking the client to prepare, in advance of the auditor's arrival, various schedules that will become a part of the working papers. The principal will ordinarily make general arrangements for such work at the time the audit is agreed to, and somewhat later the principal, with the assistance of the auditor, will prepare a list of the schedules desired. This list will be given to the client's controller along with worksheets (some of them will probably have been headed by the auditor), and the request will be made that they be ready by a certain date.

CHAPTER IV

The Procedural Review

"Internal control" is a term used by accountants to denote the procedure whereby any business policy or objective is carried into effect. The internal controls in existence during an audit period are of primary importance to the professional accountant because:

1. A knowledge of the control mechanism within a business enterprise supplies a large part of the background necessary to the conduct of an intelligent audit.
2. Good internal controls are essential to orderly business operations, minimize the time required in prosecuting an audit, and add to the significance of the auditor's report.
3. In the uniform audit certificate, familiar not only to the auditor but to every banker and businessman who has contact with the auditing profession, appears the statement that the auditor has ". . . reviewed the system of internal control . . ."
4. By custom, the auditor each year, as a by-product of his examination, calls the attention of the management to weaknesses in internal controls and suggests specific improvements.

A close scrutiny of internal controls enables the professional accountant to determine the detail that his audit must cover, and after the audit is completed he is in a position to pass on to management his criticisms and suggestions for future improvements. Good controls lead to briefer and better audits; poor controls may call for such detailed tests as those described in Chapter XIII.

How far the auditor should go in his review of internal controls varies with the instructions given to him and with his own good sense of what is fitting in individual cases. No standards of reliance on internal controls have as yet been set by the profession itself or by any regulatory body, and the practices of individual accounting firms vary widely. But the plain inference of the quoted language of the uniform certificate is that the review of internal controls is an audit necessity. The term "internal control" is quite generally regarded as not being limited to accounting controls and is certainly much broader than the older term "system of internal check," which usually has reference only to safe-

*guards over cash; but in his brief annual examination of an individual business enterprise, the professional accountant can hardly be expected to familiarize himself with every internal control projected or in force during the audit period. Many of them will be found to be related to the purpose of his survey only remotely, if at all. On the other hand, members of the profession now realize that ledger accounts are the consequence of many operating controls to which in the past they have paid but slight attention. A better understanding of these controls invariably gives color and meaning to accounts, individually and collectively, that they would not otherwise possess. An account can have no more than pallid significance to the auditor if he looks only for regularity in its component transactions. Interpreted in the light of basic business policies inherent in internal controls, the account takes on a new importance. It becomes a means of interpreting and judging the end products of management.

In general, it may be said that the auditor's responsibility for reviewing controls covers those having any material effect on financial statements. These will include controls governing accounting, reporting, prices, salaries and wages, commitments, and credits.

The auditor's study of internal controls may be called a *procedural review*, for it involves an examination of not only the character and origin of basic business policies but also the methods of enforcing them. He learns to distinguish between formal statements of policy and the policy actually being followed, since misunderstandings, or conflicts with other policies or with the beliefs or habits of individuals may operate to decrease, modify, or even destroy the original intent. In this chapter, consideration is given to the nature and sources of policies and controls. In Chapters V-XII, generally approved controls related directly to the subject matter of the chapters are listed; these may be regarded as "standard" controls that affect the quantity of work the auditor must expend before he may form an opinion of statement propriety.

Organizational Structure

A first step in the study of controls is to learn the management setup. Organizational and functional charts are helpful, but, if they are not available, the auditor can prepare his own versions as he becomes acquainted with the personnel and with the departments and functions into which the business is divided. An organization manual, sometimes available, is also helpful, provided it is kept up to date and is respected by the management. The auditor's interest lies in ascertaining where responsibilities reside and the persons with whom policies and controls may be reviewed.

An outline such as the following may be of assistance in determining the organizational structure and relationships:

Stockholders

- Nature of annual meeting
- Control by management through:
  - Stock ownership
  - Bylaws
  - Proxies
- Matters referred to and acted upon by stockholders during past 5 years

Directors

- Character of membership:
  - Management representation
  - Outsiders, how and why selected
- Frequency of meetings
- Delegation of responsibilities to management by:
  - General directive, written or oral
  - Review of proposed actions
  - Approval of reported actions
- Activities of board committees
- Classes of actions taken at periodic meetings over past year

General management

- Scope of activities of president or chief executive
- How organizational plan is set and maintained
- Selection and maintenance of effective personnel
- Setting of plans or objectives
- Controls over capital expenditures
- Operating budget: establishment and enforcement
- Coördination of top-executive activities
- Testing departmental performance

General-management delegations

- Staff vice-presidents or managers
- Management committees
- Departmental authority
- Plant and branch autonomy
- Types of conflicts and their disposal
- Service units

Stockholder Policy

Stockholders, as a rule, have virtually nothing to do with the conduct of the business enterprise they own. As owners, under the corporation laws of every state, they are the undisputed source of both policies and powers within the organization; as a group, they rarely take concerted action independently of management. In practice, independent action is rare, either because its potentiality exercises a restraining influence on those who would overlook stockholders' interests or because stockholders have no readily

available means for acting as a unit. Management, on the other hand, has devices in its favor that are supported by law and custom and that tend to perpetuate it: an annual meeting with stockholders that management usually dominates with ease, stock control by direct ownership or by proxies, and bylaws that give management technical advantages in meetings and elections. Individual stockholders representing only a minority interest are given the right, by most states, to examine the books of account and to procure other information, and the courts have often aided them in preventing undesirable management actions. But for the most part, stockholders who are not numbered among the management play no role in policy-making and administration; and in the average case, it is safe to say, stockholders themselves regard their everyday interests as being too far removed from management affairs to justify any active participation on their part. Their moral influence, however, may be potent.

A review of the bylaws and of the minutes of stockholders for a period of several years will give the auditor an accurate picture of the functions of that body, if he will but bear in mind the voting controls management may have secured by soliciting and obtaining proxies. The result of the proxy count invariably appears in stockholders' minutes.

An active, intelligent, nonmanagement minority group occasionally goes far in influencing management policies. The auditor should pay particular attention to any suggestions or criticisms made by minority stockholders, and, if he is present at the stockholders' meeting, he must be prepared to answer their questions and those of any stockholder's representative.

Board Policy

A typical board of directors has from five to ten members, consisting of management representatives and outsiders, the latter chosen for their connections or for their general knowledge of business operations. The board meets once a month at the general offices of the company and its agenda are prepared in advance by the management. Directors are chosen by the stockholders to give general supervision to the operating management. If management representatives make up the board or dominate it, the board's function may be obscured in a conflict of interests. But, as directors, they have the obligation of taking the point of view of the stockholder.

A basic function of the board of directors is to establish broad operating policies, which are administered and reported on by the management. It also makes decisions on financial problems, chooses cash depositories, appoints officers and fixes their compen-

sation, adopts pension and other benefit plans for employees (which stockholders are frequently asked to approve), declares dividends, and reviews the work of management. Meetings of directors may be attended by principal officers of the company who are not board members in order that they may report on the sections of operations over which they have charge.

In most corporate enterprise, the demarcation between board and management functions, aside from those already mentioned, is not clearly drawn. The chief executive who heads the top-management group may simply have implicit authority to act on such matters as he may choose and refer others to the board for decision. This is often the case where management dominates the board; board approval under such circumstances, especially where secured after the fact, serves merely to give added authority to action taken or to relieve management of the ultimate responsibility. A rubber-stamp board, however, serves no real function, and is something to be avoided in corporate enterprise; its character is not always indicated by the appearance of the minutes, since arguments preceding the adoption of resolutions more often than not are omitted. The auditor's information on board functions will depend on his conversations with the management and with members of the board with whom he is thrown into contact.

There may be several subcommittees of the board, such as an executive committee, finance committee, and committees that deal with officers' and employees' compensation and benefits. The executive committee is customarily given the full authority of the board between board meetings and is usually limited to members active in the management. The finance committee reviews budgets and proposed financial changes before they are presented to the full board. In his review of minutes, the auditor should recognize that the minutes of board subcommittees may be fully as important as those of the board itself.

The auditor should visualize as best he can the delegations of authority that the board has made to the management, since they are formalized in writing only in rare instances. Very general descriptions of the duties of the board and of the principal officers will appear in the bylaws; these will be supplemented in some cases by more specific general delegations from the board or by delegations to take action on specific matters.

General Management Controls

Administration, as compared with the setting of policies, is a full-time job. In small companies the burden of administration usually rests on the chief executive—the president, executive vice-president, or general manager. But in a company with a large

sales volume, several branches, or a number of product lines, the administrative task requires a division of labor among assistants—general assistants having a company-wide point of view similar to the chief executive; staff assistants each charged with a separate function such as sales, manufacturing, or distribution; departmental assistants who control, for example, different product lines; and regional assistants who operate in distinctly separate districts. These four types of assistants or any combination of them may co-exist in the same organization.

The top executive's job in almost any situation will consist at least of the following primary responsibilities: establishing and maintaining the general plan of organization and settling promptly jurisdictional problems as they arise; following up very generally on responsibilities delegated to assistants and testing their abilities frequently; setting goals of performance for the organization as a whole and its principal divisions and seeing to it that these goals are reached; and making the budget work. *General* assistants may share these responsibilities with him, acting as he would act, when he is absent or otherwise engaged, or acting on specific assignments in accordance with a preconceived plan. *Staff* assistants must be given adequate authority to establish policies and procedures within such limits as may be defined. In a single-product or single-plant organization they may be operating heads; in larger enterprises they may act in a functional capacity only, with departmental chiefs responsible for operations and reporting directly to the top executive.

The success or failure of any plan of organization may often be observed by the auditor in the administration of the budget. If the responsibility for expenditures is divided along organizational lines, as it usually must be, and the organizational heads not only recognize their individual responsibilities but demonstrate that they have complied with the expenditure pattern set for them, the auditor may be justified in assuming that at least prima-facie evidence exists that the organizational plan outlined to him is, indeed, a reality.

There are three other tests for good management that may be revealing. The first, which is an inquiry as to the existence of an ever active top-management follow-up on assignments of staff and line duties, can be made where the chief executive maintains staff assistants and at the same time has departmental or regional heads reporting to him. For example, assume a staff vice-president such as a general sales manager, and a regional branch-office vice-president to whom a local sales manager reports. Does the general sales manager go over the head of the branch-office vice-president and deal directly with the local sales manager in setting

regional policies? If so, a good deal of irritation is likely to be the result; good management calls for full knowledge and consent on the part of the branch-office head in dealing with the local sales manager, and it calls also for participation by the branch-office head in any problem relating to local policy or operating tactics.

A second test, sometimes closely related to the first, lies in observing whether adequate authority accompanies delegations of responsibility to operating heads. "Responsibility without authority" is a common complaint at submanagement levels. An operator, charged with a function that he may be able to perform, is unable to proceed because decisions having a vital effect on his function continue to be made by others; elsewhere, the needed authority may have been given, but it has not been exercised because of the lack of administrative capacity on the part of the operator. In either case, the effect is the same: a job to be done has not been done, or it has been done imperfectly.

A third test may be made of the relations existing among service units in a manufacturing plant, the supervisor of the units, and the factory divisions served. A service unit, carelessly supervised, may expand its activities unnecessarily by engaging in work that is being done or could be better done elsewhere in the plant or on the outside. Thus, a research group may be conducting experiments already made and fully reported upon by others. In a successfully managed service unit, there should be ample evidence of careful planning, periodic reviews of the unit's plans by higher authority, and agreement on the propriety of its charges to other factory units by the recipients of its services.

The Treasurer

Many professional accountants advocate the separation of the cash-receipts-and-disbursements and cash-custodianship function from the office of the controller, where it often resides. This is in line with the general notion that physical controls over assets and the accounting for them do not go well together. Where the "treasury" function has been so separated, the treasurer usually receives and deposits cash, makes disbursements, controls cashiers and disbursing agents, and maintains financial relationships with the outside. In smaller enterprises the controller's office may govern this function.

Whether the offices of treasurer and controller are combined or separated may in actual practice be a matter of no great importance. There are some advantages gained, in both large and small organizations, by combining these responsibilities under a single officer. The treasurer and controller must always work closely together on both policies and administration, and the ideal line of

authority between the two is always difficult to draw. With carefully operated internal controls surrounding the treasury function—and these should exist anyway—a combination of the two offices is unobjectionable and may improve top-management relationships.

The Controller

From the point of view of the professional accountant, the key to the most important section of internal controls is the controller. He should occupy his position not only because of his accounting skills, but also because of his independence, integrity, and general knowledge of business and business organization and management. He must be a good administrator, be able to win and keep the loyalty of his subordinates, coöperate with other members of the top-management staff and others, and forever seek improvements in management methods to the end that internal controls may be strengthened and remain strong. He should be able to train his assistants in such a way that a portion of his time will be available for following developments within the fields of accounting and administration and, where practicable, applying them intelligently to his own organization. He should constantly strive to improve internal and external reporting methods, a task never completed, and always be responsive to management and stockholder demands for information. He should not be afraid to discontinue reports no longer useful, nor to combine, add to, condense, or rearrange others to make them more useful. He should minimize the lapse of time between the occurrence and reporting of events. He should be a member of the Comptrollers Institute of America, the American Institute of Accountants, and the American Accounting Association and participate, as time and opportunity permit, in the constructive affairs of these organizations, in order that he may give a high degree of professional objectivity to his daily work. In short, he must be second to no other member of the top-management staff in his knowledge of management methods and ability to apply them; and he must view his work as being linked strongly to external standards and social controls in the interests of which he should endeavor to serve as the agent—subject, obviously, to the limitations of authority which have been imposed on him.

The controller is always one of the top-management staff. He is preferably appointed by the board, and he often reports to the board rather than the president: a practice which has been favored for many years by the New York Stock Exchange. This privilege gives him a degree of independence which many think the chief accounting and reporting officer should have.

Internal Auditor

An important linkage between management and operations is the method by which internal audit is maintained. In larger organizations the position of internal auditor has been created during the past ten years. The internal auditor reports in most instances to the controller and confines his labors to the testing of accounts and accounting procedures. Occasionally he reports directly to the treasurer, president, or chairman, and his responsibilities cover elements of industrial engineering as well as accounting. An organization known as the Institute of Internal Auditors was established in 1941 and, in time, will undoubtedly attempt to set professional standards for its members.

The work of the internal auditor may be left to his own planning, or he may follow a program outlined for him by his superior. In either case he should be permitted to act with a great deal of freedom within the organization and not be restricted in his inquiries to the accounting records and the controller's staff. He should be free to discuss the questions raised by his assignments with any person, including members of the top management, who have, or should have, any connection with the subject matter. His knowledge of administrative methods should be extensive, for even though it be the general intention to confine his efforts to accounting records and procedures, he will not get far without recognizing and dealing with the possibilities and limitations inherent in the varying combinations of human effort required to run a business. He should spend enough time with plant technicians to learn the major processes being followed and the principal problems of distribution.

Coöperation between the internal auditor and the professional accountant should have the effect of increasing the independence of the former and decreasing the quantity of detail testing performed by the latter. The public accountant may, in fact, be called upon to assist in planning the investigative program of the internal auditor and thus be able to direct attention to weak links at the operating level that he has discovered as the result of his most recent examination. During the period of the audit engagement, the internal auditor may assist in many ways, and between audit engagements he may even supply copies of his reports to the public accountant and discuss various problems with him, in this way acquainting him with some of the new problems he is likely to encounter during his next audit.

In smaller organizations a part-time internal-audit function may be carried on by the controller or an assistant. However, the effectiveness of this arrangement may in most cases be questioned,

since the "third-person" attitude so necessary to audit work is absent in individuals who have administrative as well as audit responsibilities.

Types of Policies

As the auditor studies the management and observes the interplay of relationships between organizational units, he notes the business policies which emerge at the different levels: how they originate; how they are given expression; who is responsible for their operation; who follows up, enforces, and reports on them; and, finally, how they are periodically reviewed and coördinated at the top level of management. In most cases he will find obvious gaps —controls established but not enforced, policies misinterpreted, policies originating at too low a level and not reviewed at a higher level, policies or controls needed where none exist, policies needing revision, and so on.

A policy, whether or not it is expressed in writing, may be regarded as falling under one of three classes: (1) those established by custom, law, rule of a regulatory body, or other outside source, and followed as a matter of course; (2) those established within a single enterprise at the top-management level and usually affecting the enterprise as a whole; and (3) those established at lower levels and limited in application to organizational units within the business. Typical examples of these three types of policies appear below:

1. *General policies*

The classification of accounts will follow the standard set by the trade association.

Purchasing standards will be those adopted by the National Association of Purchasing Agents.

Sales prices will conform strictly to the principles laid down in the Robinson-Patman Act.

Credit terms of 1% 15 days, net 30, will be allowed to all customers, in line with industry practices.

2. *Over-all company policies*

Product specifications will be originally established and thereafter altered only by a committee consisting of the president, chief design engineer, and the plant superintendent.

No changes in product styles will be made during a period of 18 months, commencing October 1.

No guarantees against defective materials and workmanship will be made for periods longer than 90 days from the date of sale.

No further sales on approval will be made.

Refresher courses for stenographic employees will be conducted once annually in each office.

3. *Local policies*

Office hours in the Kirkville branch will be from 9:00 A.M. to 5:00 P.M. from Monday through Friday.

No more than one dozen of product X will be sold to a single customer during any 30-day period.

Journal entries containing month-end adjustments must be cleared with the assistant controller by the 3rd.

Nature of Accounting Principles and Policies

Accounting has always been a process for recording costs and income. From this process, in the course of many centuries, procedures and principles have emerged that have contributed uniformity and hence a wider comparability and intelligibility to the results. In addition, safeguards have always been associated with accounting: safeguards against internal frauds and manipulations. They also have broadened in character and number with the passing of the years and the growth of industry. Thus, the causes which have led to the present professionalization of accountants and accounting were basic drives for intelligibility and common honesty. These motivations lie behind accounting principles and many accounting practices and have served to tinge them with moral and social implications. The nearly universal adherence to cost as a standard of value may be explained in such terms as the need for uniformity and the desire to prevent manipulation harmful to investors and consumers.

Accountants have often been inhibited in their thinking, like groups in other fields, by overlooking the definitions of terms they use. The term "accounting principle" has given much trouble; to refer to "cost" as a "principle" has been criticized, and "convention," "postulate," "standard," and other terms have been suggested as substitutes. For present purposes it may be assumed that a "principle" is simply a basic proposition which is generally agreed to and one on which various practices can be built. A "policy" may be defined as an attempt by management to apply a given principle in a specific instance, and it may take any one of several forms. When a policy is adopted, an internal control is thereby created.

The uniform certificate[1] contains the clause " . . . in conformity with generally accepted accounting principles applied on a basis consistent with that of the previous year." Two things are implied: that the auditor has satisfied himself that the internal ac-

[1] See page 208.

counting controls followed by his client conform to standard, and that they have not changed during the year.

No exhaustive statement of accounting principles has ever been prepared. The nearest approach, one particularly related to the annual audits of professional accountants, was issued in 1936 and reissued in 1941 by the executive committee of the American Accounting Association. This statement undertook to establish a series of coördinated principles relating to the financial statements of corporate enterprise, and may be paraphrased (with certain modifications by the author) as follows:

1. Accounting deals with *cost* and, through the operation of business enterprise, its conversion into cash or its dissipation as expense or loss.

2. Business management has the ever-present obligation of striving for and maintaining the *lowest possible cost* to consumers, and the accountant has a professional stake in encouraging that objective.

3. The basis of asset valuation is the price (i.e., the amount of money, or objectively established money's worth) paid in an exchange between independent parties. A lump-sum payment for a group of assets should be spread over the assets or asset classes acquired on the basis of their depreciated original costs.

4. In public utilities, and often in competitive enterprise, the excess over depreciated original cost of the price paid for an asset or asset group is regarded as the purchase of excess earning power, separable from depreciated original cost and amortizable over the years to which the continuance of the excess earning power has been imputed.

5. Where buyer and seller are under common control, the objective of lowest possible cost requires that asset transfers between them be priced at the seller's depreciated cost.

6. Arm's-length cost or (in the case of limited-life assets) depreciated cost is the only objective basis of value; it is the consequence of actual transactions and is thus comprehensible to and serves the interests of management, investor, and consumer. It is the best medium for applying both internal and external controls and for portraying the responsible discharge of management accountability.

7. Reproduction value or other hypothetical value exceeding cost varies in amount with underlying assumptions and, neither having objective existence nor reflecting management accountability, is unsuited as a basis for records or reports.

8. The cost of limited-life, service-yielding assets is allocable, in the interest of simplicity, on a "straight-line" basis, over their useful lives.

9. A portion of the cost of an item of inventory may be expensed before the item is sold in order that the remaining cost may be not greater than (a) the likely future outlay for similar items, or, if similar items will no longer be acquired, (b) the expected future disposal price less any estimated, identifiable increment in expense to be incurred in carrying or selling.

10. Discount and expense on long-term obligations is, in effect, interest not yet accrued, payable at maturity, and offsets the face value of the indebtedness.

11. Unamortized discount and expense remaining from an obligation which has been refunded are an expense of the year in which the refunding takes place.

12. Income from construction contracts or installment sales, involving periods greater than a year, may be recognized in proportionate amounts as billings are made or collections received.

13. Discovery value, timber growth, and other forms of accretion are not recognized as income until realized through sale.

14. A breakdown of sales and costs of sales by products or departments is a necessary addition to an income statement whenever the disclosure might influence the interpretations of readers of the statement; and if the trend of any of these items is significant, comparative data are also required.

15. The income statement reflects revenue and expense *recognized* during the current accounting period, notwithstanding that certain items may be associated with operations of prior years; but no income or expense may be recognized during the current accounting period in anticipation of transactions of future periods which, if they occur at all, will be dependent on decisions then to be made.

16. A special section may be provided in the income statement for nonrecurring income and expense, extraordinary losses, "prior-year" charges, so-called capital gains and losses, gain or loss from the discharge of an obligation at less or more than its recorded amount, and other items that are worth distinguishing from more usual operations. *Net* income (or loss) is what remains after all these items have been taken into account. A corollary to this proposition is that no income, expense, or loss may be credited or charged direct to earned surplus.

17. Provisions for contingencies, postwar rehabilitation, and other possible *future* losses are not items that belong in an income statement; they are reservations of earned surplus, and accumulations thereof are classifiable under that head on a balance sheet. Expenses and losses subsequently arising, and related to these provisions, belong to the income statement of the period in which they are recognized. Reserves of this character are unnecessary,

and often confuse, even mislead, the reader of financial statements.

18. Corporate net worth consists of paid-in capital and earned surplus.

19. An acquisition of treasury stock is chargeable against paid-in capital to the extent permitted by the average amount paid in for that class of stock, any excess of acquisition cost being, in effect, a distribution of earned surplus; resales may be recorded in the same manner as original sales.

20. A reduction of the par or stated value of capital stock for the purpose of absorbing a deficit is a "quasi-reorganization" subject to the approval of the stockholders; thereafter, earned surplus is so labeled as to indicate that it dates from the time the deficit was eliminated.

It is believed that the great bulk of the profession follows these principles whenever possible. It is not the usual practice, however, to take exception to any accounting policy not based on these principles where the effect is minor or the reader of the financial statement is not likely to be "misled." Thus, varied practices persist for the disposal of treasury stock, for the reason that some accountants are not yet firm enough in their belief in the universality of principle 19, above, to insist on its application to every situation. They rely, rather, upon a full disclosure of the item wherever it appears—a much less satisfactory solution, but one that will have little or no consequence on financial-statement interpretation.

A permanent-file section should be reserved for the client's accounting policies. In this section the auditor does not undertake to set forth *all* the accounting policies followed by his client, but only:

(a) Those for which no well-established general standards exist.

Under this head come policies pertaining to fixed assets. There are numerous capitalization methods in use that in the long run do not materially affect the financial statements, particularly the income statement, for any one period, provided they have been followed consistently from year to year. Often variations in method, as between different enterprises, are occasioned by the lack of any generally adopted standards because accounting has not progressed that far, or because of convenience in keeping accounts, making retirements, and so on.

(b) Those that are departures from accepted standards.

There are many possibilities here. For example, a coal-mining company records depletion at the rate of 5% of its gross business, in conformity with permissive income-tax regulations. Such a provision is a distinct departure from the usual cost basis and, in

reporting that fact, the auditor should include any data that will throw light on the actual depletion that is being, or has been, sustained, thereby giving some notion of the importance of the departure.

Where approved, commonly found practices have been adopted and the records have been carefully conformed to them, the auditor's memorandum on accounting policies may be silent. Thus, the fact that the accrual basis is being followed requires no mention because the accrual basis is all but universal; any deviation from that method should, however, be described, and a computation or other indication should be given of the practical effect on the financial statements.

Consistency in policies may continue to exist despite minor changes in method. Each year the permanent-file section on accounting policies should be corrected by a narrative added to the memorandum and a cross reference made to the matter changed.

Internal-Control Analysis

In the Illustrative Audit appears an internal-control analysis or questionnaire. Its purpose is to make the client's practices with respect to the "standard" controls a matter of record. Once it is filled out, it becomes an important section of the permanent file and is corrected and added to each year as may be necessary.

It will be observed that the analysis incorporates, wherever possible, usually accepted internal-control standards; if the auditor finds them present, he indicates a simple affirmation to that effect. Sometimes a number of standards are found in practice, any one of which meets the demand for good internal control; in such a case, the standard must be briefly described but in language that will clearly reveal its propriety.

If at any point no commonly accepted standard is being followed, the auditor must be satisfied that the procedures in force supply controls adequate for the business; or he must seek the advice of his principal in so extending the scope of his examination as to explore the possibility of irregularities of a material character, to which the existing methods may give rise. A minor weakness in internal-control methods may often be corrected at once by a suggestion from the auditor; other weaknesses may necessitate conferences with officers, followed by a memorandum to the company, particularly where serious irregularities have occurred or may occur in the future. In many instances a special letter or report, separate from the audit report, commenting on the methods of internal control, will be prepared and sent to the client. As already mentioned, this may be a regular feature of the service rendered by the auditor.

A primary requirement of internal controls is that no employee who has physical custody of assets should be permitted access to the books of account, and that bookkeeping controls for each principal class of assets not only should be in existence but also should somehow be compared periodically with the physical existence and condition of the assets themselves. In small organizations where the division of duties necessary for internal controls cannot be made, a brief narrative covering general operating procedures may be substituted for the more formal analysis; in such cases it may be necessary that correspondence with the client confirming the audit, and the audit report as well, point out the absence of such controls and the necessarily qualified nature of the examination.

In his review of internal controls, the auditor's findings must result from his personal, firsthand observations. Statements made to him by the client's employees, especially supervisors and executives, will have to be put to practical test if facts rather than allegations are to be truly recorded. The experienced auditor not infrequently finds an accounting or other procedural manual out of date, unenforceable, or not understood by those very persons to whom it was designed to apply. He knows also that nearly all well-designed and carefully installed procedures change over the course of time, and that an annual procedural review may bring to light modifications of importance, concerning which the accounting principals of the organization have no knowledge.

Standards referred to in the illustrative internal-control analysis are intended to be typical minimum requirements for the business of average size; frequently, particularly in larger enterprises, these standards may have to be altered or increased, or there may be activities for which further standards will be devised and enforced. This means that the auditor must not regard these standards as a maximum of desirable procedures; he should supplement them with an active imagination that is alive to the best modern business methods, the needs of good management, and the ways and means of bringing the two together.

CHAPTER V

Operations

A review of the top-management structure of his client's organization, such as that called for in the preceding chapter, should give the auditor a working knowledge of the basis on which the operations of the business are built. Having become acquainted with at least the major policies of the business, their sources, and the controls which give them practical effect, he is prepared to probe more deeply and understandingly into what has taken place on the "firing line" during the audit period and to interpret the main events, both ordinary and extraordinary, for that period.

This chapter contains an outline of the principal operating problems with which the auditor must have some acquaintance. In practical audit procedure, they may not be taken up in the order here presented, nor are they studied all at one time. Rather, they are considered whenever the opportunity presents itself, frequently in conjunction with examinations of related balance-sheet items. Certain aspects of operating problems are omitted from this chapter because of their close association with other subjects. Thus, maintenance and depreciation are discussed in Chapter X (Fixed Assets), material costs in Chapter VIII (Inventories), sales (in part) and bad debts in Chapter VII (Receivables), and expense accruals in Chapter XI (Liabilities). In fact, no balance-sheet item can claim the auditor's attention that does not at the same time involve various operating features. Every auditor is constantly reminded of the close interrelation between real and nominal accounts.

Operational Inquiries

In the sections following there are outlines of what may be described as the auditor's attack on operating problems. The left half of the page, "Information to be sought," represents usual lines of inquiry, not to be obtained from the records but from individuals: department heads or executives who are in the midst of, and have a hand in, controlling the several classes of operational activities shown. The right half of the page indicates the possible relation of the information obtained to the main task of the

auditor. There are obvious limitations in any practical situation: the auditor may not be able, at the time of his examination, to speak with the officials who could furnish him with the best answers; some of the responses may indicate little or no connection with the auditor's problems; and the auditor himself may not have the training or capacity to elicit informative responses from the individuals he talks to. On occasion the auditor's principal may undertake the job, especially in larger engagements where executives hesitate to reply fully to questions from persons with whom they have not been long and well acquainted.

A narrative should be prepared by the auditor before the conclusion of his field work, indicating briefly the results of his inquiries on operations. Names of persons who supplied him with information should be given; sometimes, the dates of conversations are also important. The auditor regards these comments from individuals not as conclusive evidence upon which he may unqualifiedly rely, but as useful, interpretative information that will constitute a helpful supplement to whatever testing and scanning operations he may apply to income and expense accounts and that will often obviate the need for more extended examinations of these accounts.

Consequences of inquiries on operational activities may include some or all of the following:

1. The auditor gains a better understanding of income and expense accounts and of internal controls over them.
2. He finds that certain items need a more thorough examination than they would ordinarily receive.
3. The examination of various other items may be minimized.
4. The need for a number of reclassifications and adjustments is made apparent.
5. Changes during the year in classifications, accounting policies and procedures, and the reasons therefor, may be disclosed.

Sales Activities

Information to be sought	*Information related to*
Breakdown of sales by product lines or departments.	Relative profitability of lines; disclosure in report may be required.
Comparison of breakdown with those of previous years.	Causes of changes in gross profit; trends in character of business.
Sales prospects for future.	Identification and meaning of sales-development expenses; worth of inventory, plant items; rates of depreciation.

Sales Activities (*Cont.*)

Information to be sought	*Information related to*
Trend of raw-material and finished-product prices.	Year-end raw-material inventory valuation; importance of outstanding commitments; salability of finished product.
Conditions of demand and state of competition among manufacturers.	Inventory valuation; meaning of gross-profit margin; change in sales.
Changing character of product.	Changeover costs; marketing methods; abandonment of certain operations; variations in expense ratios.
Sufficiency of margin allowed retailers in sales to consumers; retail-price-maintenance policy.	Change in sales value; meaning of gross-profit ratio; changes in customers.
Productivity of various advertising media.	Change in quantity or character of advertising expenditures.
Special incentives for increasing sales generally, in specific areas or in certain lines.	Increase in selling costs; returns of old stock; special sales prices; rebates; demonstration costs; "educational" campaigns.
Changing character of customers.	Concentration or expansion of outlets—if the former, possible sudden shifts in demands during year; new credit terms.
Commissions to salesmen or agents in varying rates and amounts; changes in personnel, distributors, or distribution points.	Difficulty in disposing of certain lines; dumping of product; new outlets secured in attempts to reach new levels of demand; commission rates and expense.
Credit terms.	Rates of discount on quantities and for prompt payment; freight and other allowances.

Sales Activities (*Cont.*)

Information to be sought	*Information related to*
Ability to meet delivery dates.	Effective factory scheduling and operation; careless methods of selling, leading to fluctuation in sales rates and selling costs.
Coöperation with factory; "bugs" in product.	Pressures to release products, particularly new lines, before solving production problems; broken production schedules originally set by factory; lack of coördination by top management of sales and production.
Development of product changes or substitutes.	Effectiveness of experimentation, designing, and other factory-controlled operations in face of new demands, or continued demands for products for which substitute basic materials are necessary.
Guaranties and changes therein.	Returns and allowances; inability to maintain sales rate or increased sales rate during year; effect of using substitute materials.
Conditions leading to returns and allowances; procedure followed in passing on claims.	Credits to customers' accounts other than cash; heavier competition; poorer quality of output; new sales policy.
Availability of repair parts and repairmen employed by dealers.	Changes in sales rates of both product and parts; increased factory costs of maintaining product.
Changes in top sales personnel, and personnel in district offices.	Changes in emphasis on product lines, and on sales expenses.
Legal problems of selling and pricing.	Observance of Robinson-Patman Act, price-control rulings, price-maintenance acts, intra-industry agreements, and possible contingencies therefrom.

Sales Activities (*Cont.*)

Information to be sought	*Information related to*
Standing of business within the industry and among competitors.	General reputation of client for doing business in certain ways may lead to new interpretations of both sales and expenses.

Purchasing Activities

Information to be sought	*Information related to*
Breakdown of purchases by classes of raw materials or parts and comparison with prior years.	Changes in purchasing conditions and volume and in costs (where analysis of quantities is also available).
Rationing and other restrictions on procurement.	Changes in rate and volume of production; more frequent purchases; smaller amounts of individual purchases; increase in number and character of suppliers; smaller average investment in raw materials and parts.
Purchasing prospects for future and for release of restrictions.	Release of desired raw materials may make part of present inventory (i.e., substitutes) obsolete.
Trend of prices during period and at end of year.	Valuation of year-end inventory; possibility of canceled commitments; effect on purchasing of raw materials by competitors.
Trend in buying finished parts *vs.* raw materials.	Tendency in either direction may affect inventory usability and pricing.
Changes in qualities of items purchased.	Quality of product may suffer from lack of pressures on suppliers, thus accounting for changes in sales volume.

Purchasing Activities (*Cont.*)

Information to be sought	*Information related to*
Holdups by suppliers and causes thereof; attempts to speed deliveries.	Delays in delivering purchases may cause breaks in or slowdowns of production and greater resultant costs.
Lapse of time between recognition of need for material and placing of orders.	Delays in procurement process may affect production or cause unnecessarily large investment in on-hand raw-material requirements; delays in making up requisitions may give too short notice to purchasing division.
Methods for obtaining lower prices; relation of prices paid to market quotations or prices paid by others.	Purchasing from same suppliers may not result in lowest possible prices, and dealing with others at lower figures may be at the expense of quality, speed of delivery, or other service.
Nature of inspection on receipt and present volume of rejections; methods of obtaining better quality.	Returns and allowances and present trend therein; likelihood of returned sales because of defective parts.
Terms secured from suppliers and how obtained.	Quantity and cash discounts, return or cancellation privileges.
Minimum and maximum inventory levels and how maintained.	Relationship between purchasing and manufacturing activities.
Reports from warehouses and stockrooms.	Reliability, usefulness, and promptness of internal reports.
Payment of suppliers' bills and taking of discounts.	Relation of purchasing activity to payments for materials and parts; satisfactory conduct of accounting and disbursement functions.

Labor Activities

Information to be sought	*Information related to*
Securing trained and unskilled employees; compliance with rulings of government agencies; relations with labor organizations.	Payroll analysis; changes in numbers of employees, and in turnover and production rates.
Rates of pay.	Payroll analysis; changes in amounts paid to employees; identification of wage groups.
Benefit plans.	New types of expenditure or reserves and changes in amounts of expenditure or accruals; details of computations.

Production Activities

Information to be sought	*Information related to*
Rate of output to plant capacity; plans for change in rate.	Change in production volume and unit costs.
Planning production; relation of budget to planning; how plans are initiated and enforced.	Comparison of performance with plan and of budgeting estimates with expenditures, and reasons for variances.
Changes in production methods —recent and contemplated.	Fluctuations in production costs; new costs incurred during year and disappearance of old costs; need for new types of equipment and disuse of old types.
Changes in product lines or in emphasis on existing lines.	Fluctuations in departmental costs.
Studies looking forward to bettering of output or decreasing its cost, or to new products.	Meaning of experimental, developmental, engineering, and patent expense and fluctuations therein; existence of high-cost factors.
Effectiveness of present buildings, machinery, and equipment; possible replacement.	Propriety of obsolescence and inadequacy factors included in rates of depreciation.

Production Activities (*Cont.*)

Information to be sought	*Information related to*
Shutdowns during period and their causes.	Reasons for idle time or sudden changes in distribution of labor and other costs.
Relations with sales division.	Nature of coördination may point to weaknesses in internal controls, the forcing of production, unsatisfactory service, continued production of unsalable line.
Relations with purchasing officer.	Promptness in securing materials, parts, and supplies; quality of purchases; success with which material costs have been held down.
Labor relations.	Quality of labor going into cost of product; variations in unit labor costs and reasons therefor.
Cost methods in use; changes during year; cost reports furnished management; promptness of such reports; nature of study given reports and action taken on them.	Usefulness of present cost controls and reports.
Causes of variances where a standard-cost system is in effect; variations in functional or object costs.	Disposal of variances; reliability of standard costs as a basis of inventory valuation; significance of actual and standard or other estimated costs.
Method of controlling stores.	Accuracy of storekeeper's records; sources of shortages.
Factory suggestions plan; review of principal awards during period.	Changes in production methods; weaknesses of methods and controls not yet corrected.

Production Activities (*Cont.*)

Information to be sought	*Information related to*
Overhead distribution; reasons for more arbitrary allocations; effect of present methods on judgments of executives; changes in distribution methods during period.	Character of present methods of distribution; accuracy of final result.
Controls over service departments; intraplant disputes over service charges and how they are settled; reasons for growth of these departments during period; degree of autonomy given service heads.	Reasonableness of service costs and character of controls over them; causes of changes in service costs.
Trends of costs.	Changes in unit manufacturing costs.

Internal Controls

Internal controls over operations are numerous, and the auditor's interest in them, it will be remembered, derives from the need of understanding the origin and meaning of transactions—to the summation of which, in the form of financial statements, he is to attach his certificate. He cannot, of course, examine each transaction; he must rely on analysis, testing, and scanning. But the worth of his examination is conditioned by his knowledge of the internal controls that have given rise to the transactions and at the same time have determined their character and amount. Conformity to the internal-control pattern does not in itself give complete assurance of account propriety; it does carry the responsibility back from those who incur expenses to those who originate and enforce policy, thus establishing a dual accountability. The propriety and effectiveness of the internal controls are also objects of the auditor's examination; he must study, appraise, and report on them in the light of what he conceives good internal-control standards to be. With respect to operating expenses, the desirable standards for a medium-size manufacturing enterprise to which it is likely that most auditors would agree may be summarized thus:

Purchases. A qualified purchasing agent should be responsible for *all* materials and equipment purchased, and he should report directly to the chief executive officer. He should act only on written authorizations from individuals whose authority and limits on

the incurring of obligations have been clearly established. He must rely on and in the end conform to specifications of others, although he may challenge those he believes too restricted, and suggest, and make a matter of record, substitutions (and where their importance warrants, refer individual cases to the chief executive officer) that would have the effect of concentrating purchases, accelerating delivery, increasing quality, decreasing price, or in other ways bringing the transaction under more desirable purchase standards. His functions should *not* extend to the keeping of quantity stock records, the control of warehouse stocks or of the stockroom or storekeepers' operations, the receipt and inspection of goods, or the approval of invoices. He should be sent a copy of receiving and inspection reports and he must act promptly on adjustments required by rejections and imperfections. He must have a workable system of unfilled-order controls by means of which he follows up with dispatch on delayed deliveries. He must send copies of each purchase contract or purchase order to the receiving and voucher-audit divisions, together with such collateral data as may be helpful in passing on invoices subsequently to be rendered by the supplier. He must give ample evidence of following the best purchasing practices and securing the lowest prices and of not having "most favored" suppliers—as the result of his own volition or as the result of adherence to unnecessarily narrow specifications. Finally, he should not be the recipient of gratuities or other favors from suppliers, although on this point the auditor has no means of, and probably no excuse for, investigation.

Receipt of purchases. The receiving division is best placed under the storekeeper in most circumstances, with responsibilities for both quantity and quality, the latter, where necessary, aided by but not subordinated to members of the engineering staff or other persons having special qualifications. Copies of purchase orders sent to the receiving division should have specifications but no quantities indicated on them, and one copy, with quantities filled in as the result of the actual count by the receiving clerk following quality inspection, should be dispatched promptly to the voucher-audit division.

Voucher audit. Under tightly fitting controls preceding the audit of invoices for materials received, the work of the voucher-audit division is limited to a review of the propriety of terms, prices, discounts, extensions, footings, receiving and inspection reports, and transportation costs—all of which should be completed on the same day or within twenty-four hours after receipt of the receiving report. Best filing practice is usually by discount date for unpaid invoices, and alphabetical sequence for paid vouchers, the latter with receiving and inspection reports and

purchase-order copy attached. Vouchers covering partial deliveries (except the final) should be referenced to final-delivery voucher (and vice versa) where but one purchase-order copy is available. Cash discounts should be taken full advantage of, wherever possible, by advance payments of invoices on which receipts have not yet been acknowledged. Petty-cash or working-fund reimbursements may be examined and cleared through the voucher-audit division.

Voucher distribution. The "coding" operation, or indication of the number or name of the ledger account to be charged and the explanation, if any, of the transaction, which is also to appear in the account, should be placed on the voucher by some person other than the posting clerk. This may be done as part of the work of the voucher-audit division. Most expenditures, often as many as 95 per cent, are routine in character and the coding operation is just as routine. The remaining 5 per cent should be tentatively coded by the coding clerk and reviewed finally by his superior before the posting operation takes place. Explanations are helpful additions to the posting operation from the point of view of both internal and external audits, and their inditing may become something of a fine art. The auditor's scanning of expense accounts is greatly aided by explanations, even though they serve only as prima-facie evidence of the nature of the posting. Explanations are also a worth-while element of internal controls, since the analysis which must precede their composition may lead to a more careful distribution of the expenditure.

An objective of every scheme of expense distribution should be to avoid redistributions by every possible effort, except for service-department costs. The more vouchers that can be posted direct to their final resting place in the accounts, the more intelligible and useful the accounts are likely to be.

Accounts payable. With adequate working capital there need be no lag between completion of the voucher audit and the preparation of the check, thus eliminating accounts payable except for the small group of items in process at the end of the period. Voucher number and check number may be the same and the check prepared for signature in the voucher-audit division. Expenditure accounts may be posted direct from vouchers, and, if bookkeeping machines are used, the backing sheet may serve as the record of checks drawn. The auditor should regard systems involving a voucher record or accounts payable as intermediate steps that may be removed under adequate control conditions, and he should regard internal controls as having been improved, at least potentially, by removing such intermediate steps and reducing the operation to its simplest terms.

Payrolls. An ideal payroll division is one that critically reviews independently determined payroll data and prepares the payroll and payroll checks therefrom. These data should include master employment cards bearing approvals of original employment and of rates of pay and changes therein, reports of time worked bearing the signatures of foremen, reports of piece-work inspectors, clock cards or other attendance reports, and authorizations for payroll deductions. It is sometimes possible to institute controls over payroll totals whereby changes from one payroll to another are effected by individual change authorizations; predetermined payroll totals may thus be arrived at. Payroll machines have been devised that greatly speed payroll work and add materially to internal controls. Checks are always to be preferred over cash distributions, and the checks should be distributed to individuals by an independent official who may be designated "paymaster." He should have authority to hold undistributed checks for a limited period, thereafter to forward such checks to some higher official such as the controller or his assistant. Where the division of authority cannot be effected along these lines, it may be desirable to have a fairly complete internal audit before payroll cash or checks are distributed.

Checks issued. It is preferable to have two signatures on each check, one indicating that the necessary accounting and pre-audit steps have been taken, the other that the proper bank account is being drawn on and that the total of the check or checks corresponds in amount to the supporting document. One of the signers should be responsible for seeing to it that the voucher and its attachments are canceled (preferably by perforation, as are checks returned each month by banks), so that they cannot be again presented in support of a proposed payment.

Monthly review of accounts. An always effective method of internal control over expenditures is to have the content of operating accounts reviewed monthly by the organizational heads primarily responsible for expenditure incurrence. This review is readily assumed, provided the content of any one account is confined to expenditures within the jurisdiction of the reviewer. The reviewer should examine each item making up the monthly total and he may call for supporting vouchers or distribution details on unfamiliar items; he may challenge any service charge or periodic fixed cost and appeal to the controller for its modification or elimination—or failing therein, he may carry his appeal to the chief executive officer of the company. Where this scheme is followed, the accounting classification must be carefully redrawn so that expenses may relate to organizational units, with subdivisions for such activities as may be defined by the organization head with the assistance

of the controller. Activities should be agreed upon that lend themselves to unit-cost analyses, or, where comparative unit costs within or without the business are unavailable or have no significance, to monthly or other periodic comparisons. Each organization head selected for the task thus becomes an important link in the fabric of internal control; he may be a top executive or the supervisor of a comparatively minor operation, but it is always preferable to select a person as far down the line as possible. Once he has made a number of monthly reviews the task ceases to be onerous. He is given the accounts pertaining to his activities, say, on the second of each month, reports not later than the fifth to the controller on any disagreement as to content, thereafter automatically keeps informed on his portion of operating costs and at the proper time each year is prepared without extended research to submit budgetary estimates for which he can intelligently assume personal responsibility. Other advantages that develop almost immediately are the following:

1. Organization heads become much more accounting- and cost-conscious; their unit costs and periodic cost comparisons can be and often are interpreted by others, particularly the top management, as indexes of their operating efficiencies and supervisory talents.

2. Not only are more intelligible budgetary estimates made possible, as already mentioned, but the enforcement of the budget becomes the ever-present, personal problem of organizational-unit heads. The budget is thus converted into a much more active agent of expense control.

3. New and valuable ideas are contributed to the problem of distributing joint or common costs, with the result that top management is soon participating in decisions on cost spreads—a situation welcomed by every controller and public accountant as a much-needed extension of cost controls and management interests therein.

4. Cross-checks are secured for service activities which auditors often find have gotten out of hand, provided, as is usually the case under any cost system, service charges are spread to product lines, production departments, or other activities which make up costs of sales.

5. A new unity is given the enterprise as a whole. It can be more clearly discerned as an organism of many parts, held together by a common interest in cost controls and by the common language of accounting.

Where these methods are employed it is usually necessary to make up new expense-ledger sheets each month. Bookkeeping machines with typewriter attachments are preferable, since they

permit explanations to be written in, at least for the more unusual items. Abbreviations and "object" codes may also be employed, and the explanations may vary in character in accordance with the wishes or needs of different organizational heads.

Cost methods. In the ordinary annual audit, the public accountant does not apportion any considerable amount of his time to details of the cost system in use. He must understand the cost basis and the general operating practices in recording and spreading costs, for he must appraise the methods of inventory valuation. In this book, valuation methods and their relation to the cost system are discussed in Chapter VIII (Inventories). The public accountant has been inclined to regard the item of cost of sales in the income statement as a residuum—a conglomerate of costs obscured by opening and closing inventory *values* and often combined in a single figure with selling and administrative expenses. Occasionally he has attempted to compare it with similar amounts of previous years and account roughly for variations. But just as the balance-sheet item of surplus has emerged as a figure with a history behind it and is no longer the excess of assets over liabilities and capital, so cost of sales is now coming to be looked upon as the resultant of the logical combination of specific costs—an item that contains the elements of its own justification.

In addition to the general cost controls given consideration in preceding paragraphs, the auditor may profitably inquire into such practices as the following, and suggest the possibilities of more carefully worked-out future controls over them:

1. Careful planning in the spread of work over the year minimizes lost machine hours and idle-labor costs. The auditor usually finds evidence of such planning. On the other hand, too frequent shifts in production schedules, occasioned by attempts to utilize facilities more fully, may in itself give rise to costly set-up time and a loss of productive hours.

2. The smallness of the balances of various materials and parts on hand at different times during the past year may point to the desirability of more carefully coördinating purchasing and stores with production.

3. Rising unit labor costs may indicate the need for the institution or revision of incentive plans.

4. Cost reports and their preparation should be reviewed for their timeliness, content, and arrangement, with the thought that they may be made more useful to management as a basis of information and control.

5. The volume of rejects arising during the year may suggest that studies to remedy the causes are not instituted quickly enough.

6. Changes in designs or specifications may have been put through without recognition of or despite their effect on materials, parts, and in-process work.

Income-Statement Standards

1. Sales and manufacturing cost or merchandise cost of sales should appear in every income statement.
2. Where an important trend would be indicated by a breakdown of sales and cost of sales, as by departments or product lines, such breakdown should appear in the income statement or be otherwise indicated thereon.
3. Returns, allowances, discounts, and freight-out should be deducted from gross sales, but their amount need not appear in the income statement unless they possess more than ordinary significance.
4. The nature and amount of any material writedown of inventory should be indicated on the income statement.
5. Substantial differences between net income in the income statement and net income for Federal income-tax purposes should be explained in a footnote accompanying the income statement.
6. Dividends on treasury stock should be credited against dividends paid and never shown as income.
7. Income earned by a sinking-fund trustee (excluding interest and dividends earned on the company's own securities) should be included in the income statement along with the trustee's expenses; gain or loss from acquisition or resale by the trustee of the company's own securities should be accounted for on the company's books as though they were the company's own transactions.
8. Recent attempts have been made to give new credence to the obsolescent notion that the income statement ought to reflect earning power. Accounting principles 15, 16, and 17 on page 48, the comment on page 11 relating to an objective basis of accounting, and surplus standard number 5 on page 168 should be examined in this connection. It has been asserted that earning power may be given expression by omitting from among the elements of net income such irregular items as those listed on page 166. The accountant, who in pursuing this aim proposes a net-income figure differing from the excess of income *recognized* and expressed on the books over expenses and losses of all kinds likewise recognized during the same period, does not reckon with the fact that much of what he regards as "recurring" income and expense—that is, annually varying portions of ordinary sales and operating-expense accounts—may actually be *non*recurring in character. An auditor who has been painstaking in his operational inquiries such as those outlined on pages 53–60, will almost

certainly discover that purely adventitious events and conditions, or events and conditions that have changed during the period, have had a surprisingly substantial effect on operations: an effect never disclosed, if indeed its existence is known, by the "earning-power" advocate. To cast out only a portion of the nonrecurring constituents of net income and to ignore the remainder is to exhibit a lack of realism not usually associated with the accounting profession. As the author sees it, no one possesses or can possess the omniscience required to segregate the elements that contribute to earning power from those that do not; hence he regards the principles enunciated on page 48 as inescapable.

Audit Procedures

1. Review comparative profit-and-loss items on working trial balance and make note of and ascertain reasons for principal variations; review client's monthly income statements and investigate and record reasons for any important item variations between months.
2. Make sure, during review of profit-and-loss accounts, that no unearned income has been included, particularly where the customer has made payment, in whole or in part, before delivery.
3. Obtain as detailed a product breakdown as possible of sales and cost of sales for a three-year period and secure explanations for trends.
4. Analyze income from rents, interest, scrap, and miscellaneous sources; review for completeness and similarity to prior year; ascertain whether any new sources of income have arisen during current period.
5. Scan any income account not analyzed.
6. Follow through selected sales transactions for principal products sold, from original order to collection of account, observing whether internal-control procedures are being observed.
7. Test selected discount, return, and allowance transactions relating to principal classes of customers.
8. Test a number of transactions involving different classes of purchases, from requisition to payment, observing procedures and adequacy of controls.
9. Review operating budget; investigate method of preparation, attention paid to it by operators, explanations of variations, and action taken when unfavorable variations are discovered. Compare with next forward budget and make note of anticipated major variations.
10. Scan factory-expense accounts for variations as between months, trends, extraordinary items, and changes in classification.
11. Analyze accounts reflecting executives' compensation, legal

fees, interest, taxes, major miscellaneous expense, nonoperating items, and unusual losses.

12. Scan other selling and general and administrative expense accounts and any minor, unclassified expense accounts, compare with similar accounts for past year, and analyze material differences; develop background of extraordinary items and discuss with management.

13. Review and prepare brief summary of basis and computation followed in preparation of current year's Federal income-tax return and in accrual of year-end Federal income-tax liability.

14. Where the auditor is to prepare the Federal income-tax return, the following items (other data may be required by changes in the tax law) should be listed on a worksheet and referenced to schedules following the worksheet, or to other sections of the working papers if the information has already been secured in connection with the audit:

Account analyses, for the year, of

Fixed assets Depreciation and amortization reserves Other valuation reserves Accrued interest payable Accrued taxes	and reconciliation with related expense accounts

- Capital stock: dates and amounts of changes
- Cost of sales: opening and closing inventories and purchases, or materials used; labor and overhead, the latter in some detail
- Officers' salaries and distribution; addresses, titles, time devoted to business, percentage of stock owned
- Donations: name and amount
- Dividends received
- Interest on government bonds; par value and class; when issued
- Capital gains and losses: description of property sold, date acquired, cost, depreciation accrued and allowed, selling price
- Extraordinary losses, detailed
- Income or expense attributable to other years
- Tie-in of reserves with expense accounts, if not clearly indicated elsewhere in working papers

Agents' reports: borrow copies for tax-department review

Tax-savings possibilities

15. Review and discuss with principal any revenue agents' reports received during year by client.

CHAPTER VI

Cash

In his review of cash and cash records, the auditor's objective is to determine whether the item of cash that will appear on the balance sheet is in fact the cash available on the balance-sheet date. Cash is the most mobile and at the same time the most easily manipulated asset, and the volume of cash transactions is usually more than double the number and amount of those pertaining to any other asset. An examination of cash must, therefore, be relatively detailed and many-sided, unless internal controls over cash have proved by thorough tests to be extremely effective.

Cash, appearing as a single item on most balance sheets, consists of cash in banks, cash on hand awaiting deposit, and petty-cash and working funds.

Cash on Hand

A surprise audit of cash on hand is always preferable but seldom possible. The date of the auditor's visit is usually made known some time in advance to members of the client's staff so that they may be prepared for him. Some auditors make a practice of counting cash on the last day of the fiscal period, thus automatically eliminating the surprise element; but they generally supplement the last-day count by another, perhaps a week or a month later. Both the surprise and last-day count are often difficult or impossible to arrange and the auditor must rely on other tests.

Where the imprest system is followed, cash receipts are deposited intact. Unusual is the circumstance that prevents the adoption of the imprest system, even by the smallest enterprise, and the auditor is justified in regarding its absence as an exceptional situation. At any moment of time, under the imprest system, the auditor expects to find cash on hand, but it will be limited to receipts since the last bank deposit.

In addition to cash that will be deposited in the bank, the auditor may find a change fund, and one or more petty-cash or working funds, all of which should appear in their full amount on the balance-sheet date. If more than one cash fund exists, it is preferable to count all of them at the same time in order to pre-

vent the substitution of the funds of one account for those of another; in some cases (see Chapter IX), it may be necessary to include securities owned in the count. The count should always be made in the presence of the cashier, and the cashier should give the auditor a receipt for its return in the form of an "OK" and a signature at the bottom of the working paper.

As a first step in counting cash on hand, checks and other paper are listed. Here, as elsewhere, the auditor may accept an adding-machine tape from a client's employee, but it will be necessary for him to rerun the tape or verify the addition mentally, since a careless or dishonest machine operator can always produce incorrect totals without leaving on the tape any indication of the amount added or omitted. Moreover, in this instance, the maker of the check should be noted on the worksheet so that each item may subsequently be traced to the deposit slip and into the account that receives the credit. Items received after the end of the fiscal period must be excluded, but if the count is being made on the last day of the period, the auditor should make sure that he has included the receipts that have come in after the last deposit on that day.

General funds and petty-cash funds at the balance-sheet date may consist in part of such noncash items as (1) checks held for redeposit, returned by the bank marked "NSF," or having improper endorsement or other fault, (2) debit memoranda from the bank and other vouchers which have been paid in cash, (3) I.O.U.'s, and (4) counterfeit or damaged currency which cannot be passed on. The auditor should always emphasize the desirability of disposing promptly of items of this character, and he should review a detailed list of them with a responsible official. Even though their total is not material, the presence of questionable items often signifies a laxity of controls, which, for the sake of the organization, should be corrected promptly, lest it reappear elsewhere with more harmful results. An adjusting entry is usually required, therefore, despite the lack of materiality; the entry is normally reversed at the beginning of the following period and the auditor should follow the subsequent history of the items of adjustment, making sure they are finally disposed of.

A certain degree of manual facility should be acquired by the auditor in the handling of currency—the counting of a pile of loose coins or a sheaf of bills—and he should know the contents of the common packages of money. These are:

Unit	*Number in Package*	*Value of Package*
Cent.................	50	$0.50
Nickel................	40	$2

Unit	Number in Package	Value of Package
Dime..................	*50*	*$5*
Quarter................	*40*	*$10*
Half-Dollar.............	20	$10
Dollar (silver)..........	20	$20
Dollar bill..............	25, 50, or 100	$25, $50, or $100
Two-dollar bill..........	50, or 100	$100, or $200
Five-dollar bill.........	20, 40, or 100	$100, $200, or $500
Ten-dollar bill..........	20, or 50	$200, or $500
Twenty-dollar bill......	25	$500

It is generally not necessary to count the contents of coin packages, but if for any reason a coin package is opened, the coins should be returned to the cashier for repackaging. On the auditor's worksheet the kinds of currency should be listed in detail.

Cash counts should include an examination of the entire contents of the cash drawer, safe, or other office repository for cash. The auditor may find small sums of money, even marketable securities, on hand in safekeeping for employees, checks to be cashed for employees, sometimes "overs" from previous cash counts, and unclaimed payroll envelopes. Where there are change funds or an office petty-cash fund in which the transactions are numerous, "overs and shorts" will be of frequent occurrence; the best practice is to account for them daily through an "over-and-short" account, thus avoiding a temporary holdout in the case of an "over" and a temptation to "lap" in the case of a shortage. Use of the cashier's office facilities is sometimes a necessary convenience for employees; more often it should be discouraged in order that the opportunities of manipulating cash may be minimized. The cashier's functions should be as direct and uninvolved as possible. Unclaimed wages should be noted by the disbursing clerk on the payroll and after a week or two returned to general cash with a credit to a special liability account, under some carefully considered form of internal control; where this is not done the auditor may find it difficult to verify the unclaimed wages that should be on hand.

Branch-office cash counts are sometimes waived by auditors, especially where the cash is limited to a small petty-cash fund. If the business is large enough to maintain an internal-audit staff, a recent examination by a member of the staff—on the balance-sheet date if a bank account of any size is involved—may be accepted, provided the usual precautions have been observed, the staff member is queried, and his working-papers are reviewed. If no internal-audit data are available, the auditor may accept the certifications made to him by the custodians of small funds or seek the help of some local public accountant if the amounts are material. Cash advanced to salesmen and other employees as a rule

can be verified only by a letter direct from the employee to the accountant; in most cases the letter constitutes satisfactory evidence of the existence of the fund.

Cash in Bank

In reconciling bank accounts, the auditor commences with the balance appearing in the bank statement at the balance-sheet date and adds and subtracts the details necessary to bring it into agreement with the balance on the books. The details obtained from the cashier's reconciliation may be classified in the following order: in-transit deposits (including transfers), outstanding checks, charges and credits originating with the bank and not yet placed on the books.

Possibly the most satisfactory examination of a year-end bank balance is obtained by the use of a "cut-off" procedure similar to the following: obtain, directly from the bank, a "cut-off" statement (with canceled checks) for a 10-day or 2-week period immediately following the year end; prepare a reconciliation schedule such as that shown below; trace to schedule year-end cash on hand to be deposited, and in-transit items and bank transfers; obtain copy of client's reconciliation at year end, including tape or other list of outstanding checks, prove footings, investigate each detail of reconciliation, and compare totals with book balance and bank confirmation.

Particulars	Balance December 31	Cut-off period		Balance January 10
		Deposits	Withdrawals	
Bank	$30,475.11	$465,896.52	$423,165.68	$73,205.95
In-transit deposits:				
Beginning	1,522.43	1,522.43*	—	—
End	—	647.88	—	647.88
Outstanding checks:				
Beginning	2,583.15*	—	2,583.15*	—
End	—	—	3,365.61	3,365.61*
Charges unrecorded:				
December	12.00	—	12.00	—
January 1-10:				
Exchange	—	—	4.00*	4.00
NSF check	—	—	40.50*	40.50
Books	$29,426.39	$465,021.97	$423,915.64	$70,532.72

* Red

A bank balance is verified by a letter from the bank directly to the auditor and is written at the request of the client, following some such form as that illustrated below:

A. L. Jones & Co.
Chicago, Ill.

January 5, 1947

First National Bank
Chicago, Ill.

Dear Sirs:

Enclosed is a form, partially filled out, that we request you to complete and transmit to our auditors, Messrs. Hyatt, Paterson & Co., 960 Hudson Bldg., Chicago. We also request that you send them direct, following the close of business on January 10, 1947, a statement of our account from the beginning of the year through that date, including therewith canceled checks and any other usual memoranda in support thereof.

Very truly yours,

A. L. Jones & Company

J. P. Stebbins
President

An example follows of a form used by auditors to make sure that the information they desire, including data on bank loans and other items, will be furnished by the bank. A number of the larger banks have their own forms for this purpose but they provide essentially the same information. Items accompanied by asterisks are the only ones filled in before the form is sent to the bank. The same information is requested from each bank with which the client has done business during the period or which has been authorized as a depository by the board, whether or not a balance remains at the end of the period.

Bank balances are also reported in monthly statements, but since bank statements may easily be altered the figures appearing on them cannot be relied upon except as prima-facie evidence. In instances now rare, the passbook may be ruled off by the bank to

Hyatt, Paterson & Co., Date . . . .
Certified Public Accountants,
Chicago, Ill.

Dear Sirs:

Following are the credit balances, subject to withdrawal on demand, of accounts appearing on our books in the name or for the account of * . . . .*

Title of Account	Balances at close of business *. 194-*	*. 194-*

The above balances are subject to restrictions as follows . . . .

Accompanying this letter are duplicates of deposit slips relating to the above accounts for * . . . .*

On *. . . . .* the above-named depositor was not obligated to this bank directly or indirectly except on the following items:

Maker	Kind of Obligation	Direct or Indirect	Date of Obligation	Date due	Rate of Interest	Date Interest paid to	Amount

Collateral or other security on the above obligations
. . . .
. . . .
. . . .
. . . .

On *. . . . . * we were holding as trustee or agent or holding in safekeeping for this depositor the following items. . . . .
. . . .
. . . .

Very truly yours,

. . . .
By. . . . .

show closing balances once a year. The same limitation applies to the passbook as evidence, however, and it is disregarded in most audits.

Amounts of outstanding checks at the year end, dates of issue, and payees, as they appear on the check register or other disbursement record, should be compared (1) with the vouchers against which the checks were issued, in order that their authenticity may be assured, and (2) with the checks returned with the cut-off bank statement. The dates of cancellation on the checks should follow within a week of the date of issue for most creditors. Each check that has been outstanding for more than sixty days should be the subject of inquiry; an item in dispute may suggest the existence of a contingent or additional liability not yet recorded. Internal controls over checks long outstanding should be reviewed, and the disposition after the previous audit of each check outstanding should be noted in the working papers. Outstanding checks at the year end should consist only of checks drawn within or prior to the period under review. The practice of holding the books open after the end of the period and adding to disbursements checks written (or cash paid out) in the succeeding period has the effect of decreasing both cash and accounts payable, and hence inflates the working-capital ratio on the balance-sheet date. Wherever this situation is found, an adjusting entry, adding such amounts back to cash and accounts payable, will be required.

Deposits at the year end are carefully reviewed. One practice is to secure copies of deposit slips for several days—perhaps the last two or three days at the end of the fiscal period and the same number at the beginning of the month following. Details on the slips are compared with the cash-receipts record and each slip is

refooted. Where the receipts are in the form of checks representing individual sales or payments on account, the comparison usually offers no difficulty. With a large number of items, items of the same amount, or a quantity of currency in the deposit, the auditor may be able to compare totals only. But the details on the slip may help him identify the dates of the various receipts that are being deposited, and he will follow up carefully any items which were not deposited within twenty-four hours after their receipt. The main object in obtaining the duplicate deposit slips is to disclose irregularities, if any, in prescribed procedures and unusual items that are put into the bank or omitted from deposits just before and after the end of the period. Deposits credited within the period must not include the receipts on any day of the following month; where this practice exists, the auditor is compelled to reduce the cash balance and charge receivables or other accounts in the amount of the cash overstatement. If the auditor is present at the end of the period, asking for duplicate deposit slips is obviated, and he is in a position to review the individual deposits just before they are made.

Transfers between bank accounts are reviewed for at least a month before and after the end of the period, and the reasons for each transfer should be ascertained, with particular attention directed to the possible "kiting" of checks. Each transfer in transit at the balance-sheet date should be examined closely. Was the check drawn and recorded shortly before the end of the period, at a time when the cash balance in the drawer bank was available? Was it deposited without delay in another bank account?

Service and other incidental bank charges and credits may appear for the first time in a debit memorandum accompanying the monthly statement from the bank. Even though small in amount, these items are best recorded in the period to which they relate, since they are usually known or can be made available by the first or second of the month, at which time the general books are almost always still open.

Cash Not Deposited Intact

Some small business enterprises—now, fortunately, few in number—make no attempt to deposit cash receipts intact and make disbursements from them. This means that the cash balance is constantly changing and that the amount on hand on the day of the auditor's count is likely to be materially different from that at the close of the fiscal year. Here it is essential that the bank balance be reconciled at both dates and the cash transactions scanned, possibly examined in detail, between the two dates. A

reconciliation statement should then be prepared along the following lines:

Balance, March 5, 1947, per bank certificate		$25,261.83
Checks outstanding, per detail which has been compared with disbursement record		5,145.13
Balance per checkbook		$20,116.70
Cash on hand, actual count		909.01
Total cash balance—March 5, 1947		$21,025.71
Total disbursements per cashbook, compared in detail with paid vouchers:		
January, 1947, page 296	$10,433.25	
February, 1947, page 310	8,242.16	
March 1-5, inclusive, page 322	2,306.91	$20,982.32
Total		$42,008.03
Total receipts per cashbook traced in detail to customers' accounts or to general-ledger accounts:		
January, 1947, page 105	$ 8,113.45	
February, 1947, page 122	14,677.32	
March 1-5, inclusive, page 124	863.80	$23,654.57
Balance, December 31, 1946, per cashbook, page 92		$18,353.46
Accounted for as follows:		
Cash in bank		$17,487.43
Cash on hand		866.03
Total, as above		$18,353.46

Cash at December 31, 1946, should be supported by the verified reconciliation of the bank balance and a statement supplied by the cashier substantiating the cash balance on hand at that date.

Valuation

Occasionally the rule of valuing current assets at the lower of cost or market may be applied to cash. Balances in foreign banks are converted at cost, or at current exchange rates if the amount resulting from the conversion is less, and reserves are provided for the estimated unrealizable portion of frozen balances. Cash in the hands of a closed bank is valued at its realizable amount and is classed with accounts receivable on a balance sheet since it is not subject to check.

Cash Frauds

The term "fraud" is usually associated with cash losses. However, merchandise and other assets, as well as cash, may be appropriated, even under well-operated systems of internal controls, and the auditor must always bear this possibility in mind.

In reviewing cash, an awareness of how various cash frauds are committed will assist the auditor in recognizing similar situations when he runs into them. Following are some of the types:

1. Not recording a cash sale
2. Recording an amount less than that received
3. "Padding" or overstating a payroll
4. Raising a check, after it has been returned by the bank, to agree with an overstated entry in the cash-disbursements record
5. Forging a signature on a check
6. Forging an invoice
7. Making out a false cash voucher
8. Understating a cash discount on a purchase
9. Overstating a cash discount on a sale
10. Entering an unauthorized or overstated allowance
11. Forcing a footing to make the cashbook balance
12. "Kiting"
13. "Lapping"

"Kiting" is the act of drawing and cashing an unrecorded check on one bank, followed shortly by drawing an unrecorded check on another bank that will act as a deposit to cover it; the second check, in turn, is covered by a check drawn on a third bank, and the process may go on indefinitely among several banks. The time taken for checks to clear through banks is thus taken advantage of in order to cover an unauthorized "borrowing" or theft of money. A necessary part of the kiting process is to overstate the cash account by having entered as a deposit in the year under audit a check drawn as a disbursement of the succeeding year. A rough comparison of cash deposited with total credits to accounts receivable may indicate that kiting has been going on.

"Lapping" is not an unusual procedure for a defaulting cashier to follow, since it affords a comparatively easy way of obtaining cash for temporary use and then replacing it later, provided the perpetrator does not get in too deep. Under this system the cash received, say, from a customer, is withheld, but on some later date entered as a credit in the cash receipts book. On or before this date other remittances are withheld and the cash deposited in the place of that retained the first day. Thus, except for the first day on which the fraud is committed, the total amount of receipts is actually deposited unless, of course, the process is repeated. The

detection of such fraud can usually be ascertained by comparing the detail on deposit slips with entries in the cash-receipts book. In making this comparison the auditor must be positive that the slips are copies of those actually used in making the deposit; this can be verified at the bank. Since most banks file deposit slips by days, their officials have become accustomed to requests of auditors, and the auditor need not be afraid of imposing on any bank's goodwill by asking permission to inspect a reasonable number of deposit slips or requesting certified copies of them.

Internal Controls

Cash receipts. Receipts of cash are satisfactorily safeguarded in most cases by controls established over (1) incoming mail, (2) collectors, (3) cash sales, and (4) bank deposits. Incoming mail should be opened under the supervision of some person other than the cashier or accounts-receivable bookkeeper, and a list made of checks and cash, the detail of which is later compared with the cash-receipts book or the items on the bank-deposit slip, or both. Collectors who receive cash directly from customers may give only temporary receipts; customers are informed that official receipts will be sent to them when the money has reached the collector's office. Cash sales should be registered mechanically in the presence of the customer or recorded in sales books, totaled and compared daily with the cashier's deposits. Receipts, both checks and cash, should be deposited intact. Each bank-deposit slip, covering no more than one day's receipts, should be compared with the details of the receipts record, and the deposit should be made by an employee or officer independent of the cashier or the receivables bookkeeper.

Cash disbursements. Disbursements should be made by check, each check accompanied by a supporting voucher that is examined for authorized signatures by the signer of the check. A petty-cash fund should be maintained for small disbursements, and reimbursed upon presentation of signed receipts or vouchers.

Cash balances. Monthly bank reconciliations should be made by persons having no custody of, or other connection with, cash or receivables. Sometimes the internal auditor does this, but, as noted in Chapter IV, the function of internal audit is best performed when the internal auditor is free from administrative work. Like the external auditor, he should be available for testing the performances of others.

Bonding employees. Every employee who has access to cash, negotiable paper, or other personal property that may be appropriated to his own use, should be bonded. Ability to furnish bond

should be a condition precedent to employment. Premiums should, of course, be paid by the employer. Blanket coverage is the rule in many concerns.

Balance-Sheet Standards

As already noted, the one item "Cash" may appear on the balance sheet; it will be understood to cover bank balances, cash on hand, and petty-cash and working funds.

Bank balances should be free and unrestricted and subject to check for the full amount. Some banks require minimum balances or balances having a minimum percentage relationship to outstanding bank loans; these minimums are not to be considered restricted because the bank will ordinarily honor checks drawn upon them. The formal letter from the bank to the auditor will bring out any such restriction on availability. A restriction should be noted on the balance sheet.

A question is often raised as to the practice of offsetting bank overdrafts against other cash balances, with the net amount appearing on the balance sheet. If this procedure is adopted, the primary purpose of a balance sheet is defeated, and an actual liability will have been set off against an asset. Of course, no business enterprise will have a bank overdraft if its funds have been carefully controlled.

Cash available only for construction or other noncurrent purpose, such as the proceeds of a bond issue or cash in a sinking fund, should appear "below the line," that is, not shown as a current asset.

Audit Procedure

Where the internal controls surrounding cash are exceptionally complete, the auditor's examination may be relatively simple. He may omit the count of cash on hand at the balance-sheet date or at the time of his audit, relying on the verification of undeposited cash at the year end through the bank deposit of the day following, and on the verification of petty-cash and other funds by the internal auditor whose count he will review. He may omit an extended examination of bank accounts, relying on careful reconciliations by persons having no other responsibilities for cash, and on a comparatively brief examination of checks outstanding at the year end that are sent directly to him, with a cut-off statement, by the bank. The minimum procedure follows:

1. Prepare standard letter to bank, for client's signature, with copy to auditor, requesting that year-end balance be confirmed, and that as at later date (preferably one month or less after year

end—the "cut-off" period) bank statement with related canceled checks be sent direct to auditor. Request also duplicate deposit slips if procedure No. 11, below, is to be followed.

2. Arrange, in numerical order, canceled checks returned with cut-off statement, and:

(a) Compare them with year-end outstanding-check list, and trace open items remaining on such list to cash book;

(b) Examine large or unusual items, and those representing payments to employees (excluding ordinary payroll checks), banks, related offices or companies, and petty cash. Record and investigate any irregularity in date of issue, name, signature, endorsement, or date of cancellation.

3. Trace, to cut-off statement, year-end cash on hand to be deposited, and in-transit deposits and bank transfers.

4. Obtain copy of client's bank reconciliation at year end, including tape or other list of outstanding checks, prove footings, investigate each detail of reconciliation, compare totals with book balance and bank confirmation, and dispose of any unusual items.

5. Determine whether any checks, shown as issued on or before year end, were on hand on that date.

6. Compare totals of receipts and deposits for 5-day period or more before year end and for cut-off period, in order to note whether they correspond and whether deposit has promptly followed receipt; if not, ascertain reasons.

7. List and trace recorded bank transfers for same periods as in No. 6, and determine why such transfers were made.

8. Scan general-cash, petty-cash, and working-fund counts or reconcilements at year end for independence of counts; review accompanying reimbursements, advances, holdovers, NSF checks, and general method of operating such funds. Scan one month's transactions involving each fund.

9. Determine restrictions, if any, limiting use of any cash balance.

Many auditors take the position that only in the largest enterprises will it be possible so to abbreviate the examination of cash, and, even then, merely in those instances where internal controls as a whole are unimpeachable. They contend further that a greater coverage of cash transactions is indispensable to the annual review of internal controls, is dictated by long-established custom, and has a strong inhibitory effect on employees who handle cash. The following additional procedures may, therefore, be regarded as satisfying the demand for greater coverage in all situations or simply in those cases where internal controls are not as strong as they could be.

10. Count general cash, petty cash, and other funds on hand, at year end or at cut-off date, where possible, in presence of client's representative, and:

(a) Secure cashier's signature on working-paper record of count;

(b) Reconcile count with books, and trace general-cash and other deposits into next regular bank statement;

(c) Investigate noncash items, and secure approval of higher official on such items, if significant;

(d) Scan transactions during period, if any, between year end and count.

11. Extend procedure in No. 6 by obtaining certified duplicate deposit slips for same periods and for undeposited cash on cut-off date; trace items thereon, where possible, to cash-receipts record, and trace totals to recorded deposits.

12. Foot cash-disbursements record for final month, trace to general ledger, and prepare tape of debits and credits on final month's bank statement.

13. Examine, as in No. 2, above, canceled checks returned with year-end bank statement, trace them to cash-disbursements record for final month or to preceding month's bank reconciliation and account for missing serial numbers in connection with checks issued during month.

14. Verify total of recorded receipts during last month of fiscal year and trace to recorded deposits, general ledger, and bank statement, thus extending No. 6, above, back a full month.

15. Obtain copy, prove footings, and examine details of client's bank reconciliation at end of next to last month preceding year end.

16. Perform operations Nos. 12-15, inclusive, for some other month within the audit period.

17. Scan and foot cash-receipts and disbursements records for one or more months within period, and investigate unusual items.

CHAPTER VII

Receivables

"Receivables" is a term applied to amounts owing from customers, loans and expense advances to officers and employees, and other types of items that may be looked upon as being in the process of liquidation and as being held for that purpose. Receivables take many forms; they are the consequence of oral or written agreements, purchase orders, contracts, cash sales in transit (C.O.D.'s), loans, returns of material to or overcharges by suppliers, and so on. In each case there must be an expectancy of the eventual receipt of cash or money's worth, equal in amount to the receivable, less, in many sales transactions, a possible discount for prompt payment, and certain other allowances. The term may be modified by "gross" or "net," the latter meaning the result obtained by subtracting prospective allowances for which one or more reserves have been provided. Long-term receivables generally refer to accounts that will not be liquidated within the next twelve months.

Accounts with Customers

Transactions with customers that result in receivables are supported by centuries of custom and law. The event from which a sale occurs and a receivable arises is conceived to be the delivery of goods to the customer or to a carrier or other delivery agent—the point where title passes. Trade practice varies somewhat and there may be deviations from this rule, but, in almost every case, the deviation is not important provided the practice is general within the industry (i.e., is commonly understood and agreed to by seller and buyer) and the same practice is consistently followed from year to year. In certain types of transactions, particularly those involving long periods of time or sales of services, the agreement between the buyer and the seller may specify the conditions under which partial billings may be made. An architect, for example, may bill a portion of his fee when the plans are accepted, another portion when a construction contract is let, and the balance when the structure has been completed. The contract with his client will so specify. This should not be confused with understandings between buyer and seller as to the method or time of

payment. The architect's full fee is dependent upon events that may never occur, and he records no income from services until the anticipated event has taken place. But an agreement permitting merchandise to be paid for two months after its transfer from seller to buyer does not defer the date of sale; the whole transaction is recorded as a sale when the transfer is effected.

A sale to the supplier of goods or services is a purchase to buyer, the tests being identical. At the end of every fiscal period, however, there will be goods in transit that will have been recorded as sales but not as purchases. End-of-the-year sales may have important effects on the seller's net income and the rules are likely to be rigorously applied; but since recording purchases in transit has no effect on the buyer's profit and does decrease the working-capital ratio, the rules tend to be relaxed on the other side of the picture. The better practice for the buyer is, of course, to record goods in transit as inventory, in-transit items being reflected in invoices or shipping notices indicating that the date of shipment was on the balance-sheet date or preceded it.

Records of customers' accounts vary greatly. They may in some cases be found in old-fashioned, hand-posted, bound ledgers; in other cases, a retained copy of the invoice may serve as the ledger, and a typed list of invoices not marked "paid" at the year end may be the "trial balance," supporting the balance-sheet item of receivables.

Certain receivables are referred to as *accrued*. These cover interest, rent, and various other forms of income having a future due date which is one of a series of fixed intervals of time, and relate to periods of time already elapsed. In the average commercial enterprise they are minor in amount and their establishment at the balance-sheet date is often neglected. The auditor's attitude is guided by their relative size and their consistent treatment from year to year. The current financial position of a building corporation would be seriously understated if accrued rentals receivable were omitted, and the auditor would insist on their inclusion, notwithstanding that the effect on the income statement might be nil if they were omitted both at the beginning and the end of the income period. Accrued rental receivable of $50, as an item of unpaid miscellaneous income of a manufacturing concern having a net profit of a million dollars, is in itself a wholly unimportant item; the auditor's only interest in it would be to ascertain whether the sum total of all such unrecorded miscellaneous income accruals has any material bearing on the income statement or financial position and to make sure that the internal controls over miscellaneous receipts are adequate.

Goods shipped on consignment are sometimes treated as ordi-

nary sales. Such items are a part of the shipper's inventory and must be so classified.

Amounts of claims covering losses arising from shipments and other damages may be placed on the books when the claims are filed. This procedure affords a book control over a troublesome type of transaction and insures a future follow-up, but the usual practice is to provide an ample reserve to absorb claims disallowed.

Installment Accounts

In most installment sales, title passes to the customer when the last payment has been made; sometimes it passes at the time of initial payment or when a certain portion of the total price has been paid, and a chattel mortgage or other form of lien may be taken for the balance unpaid. Because the customer usually has the full use of the asset, the sale is customarily recorded as such at the outset. For income-tax purposes the income derived from installment sales may be spread over the period of collection and the accounts may reflect such procedure; but, at present, the auditor finds the installment method of accounting much less common than formerly. The advantage of the method, from the income-tax point of view, arises only from the deferment of profit from large, isolated deferred-payment sales. Where installment sales occur in approximately the same volume year after year the net income subject to tax tends to remain the same regardless of the method of accounting, provided the method is followed consistently.

Equipment sales made under lease-purchase agreements are generally regarded as sales, notwithstanding that title does not immediately pass and that a legal claim may not yet exist for the full amount of the recorded unpaid balance. The test of validity as a receivable rests on the probable continuance of collection until the account is fully paid. Past experience should reveal, however, that comparatively few repossessions have resulted from such sales and that similar results are to be expected in the future.

Officers' and Employees' Accounts

Amounts shown as owing from officers and employees should be studied for the purpose of determining their sources and the meaning of the balances unpaid. In some states loans to officers are forbidden. In any case, large accounts should bear the approval of the board of directors and the auditor should note whether collections have been in conformity with the board authorization. Expense advances to employees should be authorized and, from time to time, reviewed by an officer of the company. Variations in this group of receivables just before the year end may be fol-

lowed by similar variations, in the other direction, immediately thereafter. It is always important, therefore, to scan the transactions in these accounts after the year end for such possibilities.

Notes Receivable

In the average situation, notes receivable are regarded as a somewhat more tangible and, at the same time, more liquid form of obligation. Yet they may be little more than a converted account receivable: an acknowledged debt the collection of which has been difficult.

If notes receivable are examined after the balance-sheet date, some notes will have been paid and returned to their makers, while others will have been sold or sent to banks and attorneys for collection or as collateral on loans. In lieu of a physical inspection of the notes not on hand, entries for cash receipts may have to suffice for those paid, and correspondence with banks and attorneys examined for those still unpaid but not in the client's possession. The only certain way of establishing the validity of notes, paid or unpaid at the date of audit, is by communication with makers. A notes-receivable register, incidentally, is always a valuable reference for the auditor; information may often be found therein that does not appear on the notes themselves.

Protested or dishonored notes are, as a rule, regarded as accounts receivable together with the amount of any protest fees and other collection expenses. An overdue note may be as good an asset as an account remaining unpaid after the agreed credit period, and both are subject to practical judgment as to their eventual collectibility.

Collateral held as security on a note may have a bearing on the adequacy of the reserve for bad debts. Depending on audit arrangements, the auditor may in some cases examine it in detail; in others, he may test it or examine internal reports covering its review.

Discounted and Pledged Receivables

Both accounts and notes may be sold or pledged or hypothecated: a procedure sometimes followed in order to increase working-capital cash. When sold, a discount covering interest (and risk also if the sale is without recourse) is deducted by the buyer, and the customer may be notified of the sale, in which case the buyer collects. Most such sales are with recourse, which means that the buyer may collect the full amount from the seller if the customer does not pay the account or note when it is due. When accounts receivable are pledged against loans or accounts payable, the act is evidenced by an agreement and a list of pledged receiv-

ables. The list is modified periodically as the receivables are paid, and the proceeds may or may not be deposited in a special bank account (or paid directly to the bank or creditor in the gradual reduction of the indebtedness). When notes are pledged, the creditor usually takes physical possession. "Hypothecation" is a term sometimes used in place of "pledging" where the receivable (note or account) remains in the hands of the debtor but is stamped with a reminder that the proceeds therefrom are to be applied to the account of a designated creditor.

Proceeds from sales of discounted accounts and notes are generally credited direct to the receivable along with the discount; the latter may be regarded as a deferred expense to be written off over the normal "holding" period of the account or note or, preferably, as an immediate expense, since it closely resembles a cash discount. Where an account or note is sold with recourse, a contingent liability is created that exists until the debt has been paid; better practice dictates that the proceeds be carried in a separate account prior to that event.

Trade acceptances are a variety of notes receivable. They are taken in payment of specific shipments of merchandise and are immediately negotiable. When they are sold, the same contingent liability attaches as in the case of other forms of commercial paper disposed of.

Sales

The auditor must be familiar with the methods followed in securing and recording sales; in fact, his examination of this main source of gross revenues preferably precedes his audit of receivables. In connection with his procedural review (Chap. V, pp. 53-56), he has already acquired a working knowledge of the significance of the sales account and the conditions under which sales are made.

Passage of title accompanied by the creation of a legal claim against the buyer is the usual test of a sale. Comment has already been made, however, that neither may exist in the case of installment sales, lease-purchase agreements, and similar transactions where the seller protects his receivable by retaining title. The auditor must be guided here by past experience, probable future experience, practice within the industry, and consistency as between years.

Construction work in process that may extend over comparatively long periods may be billed in installments. The contract may provide for periodic billings, and the auditor under such circumstances must make sure that the conditions precedent to the billings unpaid on the balance-sheet date have been met. Other construction in process may appear as a receivable that has not

been billed but that is based on cost plus a portion of the profit expected on completion. The better practice is to separate such an item for balance-sheet purposes, and the auditor must make sure that the profit included has been adjusted for contingencies, guarantees, and other possible losses, and that its ratio to total profit does not exceed the ratio of costs already incurred to total costs. Past experience on similar types of construction is likely to be a helpful guide.

Sales are preferably shown net, after deducting trade and cash discounts, rebates, returns, and freight and other allowances. Sales statistics such as departmental breakdowns may be on a partly net basis because of the difficulty of spreading cash discounts. Commission expense may be more in the nature of discount than expense; if so, it too should be deducted in determining net sales. Bad debts or provisions therefor are rarely shown as a sales deduction but are classified as an administrative or selling expense. It may be, however, that the tendency in the future will be to regard bad debts as being on a par with discounts—a portion of the sales figure that will never be realized—and thus a deduction, along with discounts, from gross sales. "Cash discounts" is still found frequently among "expense accounts," and it might even appear as a "financial" expense; however, with the prompt payment of invoices which takes place in ordinary times, it has now become fairly well recognized as a sales deduction.

Reserves for Bad Debts and Deductions

The possibility of bad debts among accounts and notes receivable is almost always present. Occasionally, the auditor finds the risk of collection slight where the number of debtors is not large and each has a recognized credit standing. Whether the risk exists and whether it is material are matters of judgment which the auditor as an independent examiner must establish for himself. His conclusions are based on past experience, the appearance of outstanding balances, and credit conditions generally. Past experience may be epitomized by comparisons for several years of actual bad debts with sales, provided their years of origin can be identified, and with year-end balances. The appearance of outstanding balances refers both to individual accounts and the age groups into which they fall. General credit conditions refer to periods of prosperity or depression for industry as a whole and for individual industries and types of business enterprise.

An illustration of an auditor's study of a bad-debt risk is given on the next page. Three "figure" sections of the worksheet may be observed. The first contains a summary of bad debts (actual prior to December 31, 1945 and estimated in the case of balances

unpaid on that date) for a period of five years, broken down by years of origin. In the second worksheet section, which has been derived from the first, ratios are computed showing the relation of the portions of uncollectible sales and remaining receivables to the total of collectible and uncollectible. The third section contains a comparative aging of outstanding receivables at the beginning and end of the year and what appears to be an arbitrary selection of ratios used in the determination of the uncollectibility of the several age groups. However, the first ratio, .0015 (.15 per cent), reflects the average relationship, for at least the past two years, between estimated bad debts (including, in part, actual charge-offs) and net sales, the derivation of the ratio being shown in the second section of the worksheet. The other percentages are experience percentages and the overall average, 1.70 per cent, coincides with the second average ratio appearing in the second section of the worksheet: the relationship, at the end of each of six years, of estimated bad debts (with the obvious advantages of hindsight applied up to the end of 1945) to outstandings. Thus the bad-debt percentage applied to 60 per cent plus of the receivables and the average over-all percentage are both justified by past experience. With a fairly large number of customers (520) and with 519 of them having average unpaid balances of something over $550 each, the bulk of the risk seems well spread. This analysis is not intended to be a pattern to be followed in all cases but simply an illustration of what can be done with certain types of information that are often available.

Estimates of bad-debt-reserve requirements should include the several varieties of receivables that will be classified under that head on the balance sheet. Following his own first estimate of what such requirements should be, and with an aging schedule at

A. L. Jones & Co.

G/L a/c 4114+ supporting file — Bad-debt analysis December 31, 1945 — E.M.B. 4/26/46

Year of Sale	Year bad debt discovered and charged off (net) 1941	1942	1943	1944	1945	Estimated uncollectible at 12-31-45 (see below)
1940 and prior	1,445.06	743.92	46.21	5.20	—	—
1941	687.45	787.95	760.22	32.18	75.43	50.00
1942		1,547.33	881.49	683.91	122.00	175.24
1943			1,496.85	624.53	342.11	454.10
1944				1,021.03	777.40	1,836.25
1945					1,186.29	2,635.02
Totals	2,132.51	3,079.20	3,184.77	2,366.85	2,503.23	5,150.61

Year of Sale	Total uncollected and estimated uncollectible at 12-31-45	Net Sales (000's omitted)	Rates of uncollectibles to net sales	Uncollectible at end of year of sale	Outstanding accounts at end of year (000's omitted)	Ratio of uncollectibles to outstanding accounts
1940 and prior	2,240.39	1,843	.12%	2,240.39	156	1.45%
1941	2,393.23	1,827	.13	2,501.11	132	1.89
1942	3,409.97	1,932	.18	2,831.88	150	1.89
1943	2,917.59	2,108	.14	2,564.70	161	1.59
1944	3,634.68	2,110	.17	3,832.53	225	1.70
1945	3,821.31	2,275	.17	5,150.61	303	1.70
Totals	18,417.17	12,095	.15%*	3,186.87*	188*	1.70%*

Age	Number of a/cs	Amount		Uncollectible		Collections 1-1-46 to 4-25-46
		Last year	This year	Percentage	Amount	
Under 30 days	412	135,687.20	228,916.41	0.15	343.36	212,139.50
30-60 days	130	64,803.02	52,510.00	2.	1,050.20	
60-180 days	31	17,786.50	9,567.41	5.	478.37	53,004.11
180-360 days	22	5,487.26	7,630.92	10.	763.09	
1-2 years	3	806.21	3,672.50	50.	1,836.25	10.00
Over 2 years	5	563.15	679.34	100.	679.34	—
Totals	520**	225,133.34	302,976.58	1.70*	5,150.61	265,153.61

* Averages
** *Different* customers at 12-31-45

The Company's average experience with bad debts has been quite uniform. The reserve balance of $5,150.61 is the result of the computation shown immediately above, and the two most significant percentages (0.15 per cent and 1.70 per cent) coincide with the averages for the past five years.

Collections to April 25 were obtained by taking a tape from customers' ledgers. In the balance of $37,822.97 uncollected on that date the principal item is $15,244.20, due from J. L. Maxton Machinery Corp. This customer has always been "slow pay"; according to B. L. Borsch, credit manager, a promise to pay one-half of this balance on May 15 and the remainder on June 15 was made during the past week over the phone. He states that past promises of a similar nature have always been kept. The G & A (local credit agency) rating is A2A (good risk but slow).

hand, the auditor should consult with the credit manager, particularly with reference to the larger, older balances, and obtain his estimate of reserve needs. Confirmation tests are valuable primarily as a verification of existence of accounts on the balance-sheet date; they do not always throw light on collectibility.

An aging schedule is simply a columnar breakdown of total receivables by dates of origin. A common standard for such a schedule is to show totals of unpaid billings originating in the first,

second, and third months, prior to the balance-sheet date, and in the period preceding the third month. Another example may be found in the illustration on the preceding page. Individual accounts will be divided between columns where invoices for more than one month remain unpaid. Cash received during the same period is applied against the charges to which it relates, which normally would be the earlier charges. However, the auditor must be on the lookout for old balances that have been carried forward unliquidated for some time. An aging schedule is a good example of a worksheet that is best prepared by the client's staff; the auditor will, of course, test its accuracy before making use of it.

A summary of collections applicable to the receivables on the balance-sheet date should be obtained wherever possible, broken down according to the aging classification. Such a summary may be of considerable help in evaluating the bad-debt reserve.

In addition to a reserve for bad debts, and notwithstanding the credit position of debtors, other reserves may be necessary for deductions that are customarily allowed, such as discounts, returns (less, of course, amounts that will likely be charged into inventory), freight, and spoilage. Cash discounts may be omitted from the requirement estimate if they have consistently been regarded as an expense of the year within which the discount is actually taken. The need for such additional reserves will depend on the importance of the maximum amount that may be involved. A rule-of-thumb test sometimes applied is that such reserves should be provided if the net deductions collectively are likely to exceed two per cent of the receivables outstanding. Past experience may be invoked by comparing several years' actual deductions with collections from customers during the same periods. Opinions as to possible changes in these averages should be sought in the auditor's discussions with the credit manager and possibly the sales manager. A summary of the actual experience with deductions after the balance-sheet date and before the audit is completed, if this period is, say, more than a month, may be all that is required to determine how material the deductions are likely to be.

Circularization

Testing accounts receivable by correspondence, or circularization, is now an accepted practice in annual audits. Its purpose lies in the prevention and detection of fraud. The "positive method" is to request customers to indicate directly to the auditor whether or not the stated balances are correct; the "negative method" is to request customers to reply only if balances are found to be incorrect. In a few cases the whole customer list, including even those whose accounts show no balances at the year end, is

circularized; but the testing principle is usually followed. This involves selecting the largest accounts that collectively will total, say, one half of the dollar amount outstanding, and picking at random another 10 per cent or more of the balance, making sure that samples are selected from each class of customers in accordance with the testing principle laid down in Chapter II. Regardless of which of the two methods is adopted, a return envelope requiring no postage and addressed to the auditor (at his home office or local post-office box) is enclosed with a statement of the account, and mailed, under the auditor's supervision, to the customer.

An answer cannot be expected from every request sent out; but if favorable replies are received from at least one-half (under the first method), or unfavorable replies from not more than one per cent (under either method), the propriety of the balance may be assumed. It is customary to follow up large amounts making up the bulk of the accounts outstanding until replies are received. Replies that indicate differences are promptly investigated; minor adjustments found necessary can be made in the subsequent period.

Where internal-audit procedures include a carefully worked-out program of circularization, tests being made on several unannounced occasions during the year, the auditor may limit his inquiry in this connection to a review of the method followed and results secured.

The following form is characteristic of those used in positive confirmations:

(Date)

(Name and address of customer)

We enclose a statement of your account with us. If you find it is in agreement with your records, please confirm the balance to our auditors, Messrs. Hyatt, Paterson & Co., 960 Hudson Bldg., Chicago 3, Illinois, using the form below and the enclosed return envelope for reply. If it is not in agreement with your records, please furnish them with whatever information you may have that will help them in determining the cause of the difference.

This is a request for the confirmation of an account balance, not a request for payment.

(Signature of company official)

- -

(this portion may be detachable)

Messrs. Hyatt, Paterson & Co.,
960 Hudson Bldg.,
Chicago 3, Ill.

The statement showing a balance of $................*
agrees with our records at......................except
for the following:

____

____

____

____

____

* To be filled in by auditor

If the confirmation is to be a negative one, the second and third sentences of the first paragraph may be replaced by the following:

> If you find it is *not* in agreement with your records, please furnish our auditors, Messrs. Hyatt, Paterson & Co., 960 Hudson Bldg., Chicago 3, Illinois, with whatever information you may have that will help them in determining the cause of the difference, using the form below and the enclosed return envelope for reply.

Internal Controls

Internal controls over receivables commence with sales. The objective should be to insure that sales and receivables accounts are neither over- or understated and that classifications have been accurately made. Safeguards over receivables merge at a number of points with those that apply to cash.

Separate controls should exist over:

1. *Original sales orders.* Sales orders when received should be reviewed in the sales department for price, delivery date, guarantees, and special features not within the discretion of the sales agent or branch to approve. Where the supply of the product is limited, the sales office maintains constant contact with the storeroom and determines the sequence in which the orders are to be filled. The sales office also makes periodic reviews of billings to make sure that approved orders have been invoiced and shipped.

2. *Credit approvals and terms.* The credit office in the organizational pattern may be subordinated to the controller, treasurer, or office manager; it is preferably not a part of the sales organization. The credit manager should operate with a great deal of

freedom, and the auditor in reviewing his procedures should make sure of that fact. If he does not, the risk of collection may be greater than anticipated in normal cases, and the bad-debt experience as reflected in the charge-offs during the year may be unfavorable. On the other hand, the credit manager may not share his responsibility with his immediate superior as often as he should. Ordinarily, pressure from the sales division affords an adequate counterbalance for the conservatism of the credit granter. But, occasionally, the auditor will find that the credit office has subordinated its own opinions to those of others and that the result leaves something to be desired. Where this condition exists, the auditor should review the problem with the credit manager's superior. The auditor should also ascertain, in his review of credit-office procedures, that both commercial standards and company policies are being followed in extending credit and in making collections.

3. *Invoices and statements.* The billing function may be a part of the controller's activities or it may be attached to the sales office. It should always be completely separated from accounts-receivable ledger-keeping, and its activities should include shipping-office contacts that make certain that shipments have been made and that the necessary shipping data are accurately set forth on invoices. The billing division usually accumulates monthly dollar totals for controlling-account entries. It may also prepare sales analyses, and quantity summaries needed in maintaining inventory controls.

4. *Bookkeeping.* Accounts-receivable bookkeeping should be an independent unit wherever possible, with separate sources for all entries made in customers' accounts: for example, invoice copies from the billing division; cash-receipt slips from the cashier; credit memos, credits for returns, and bad-debt-authorization write-offs from the treasurer's office; journal entries, covering other transactions, from the controller; control totals from the general-ledger bookkeeper. Many business concerns no longer issue formal monthly statements but rely on payment being made from individual invoices. In organizations such as department stores, payments by customers are made *only* from monthly statements, and it is usual to have third persons (an assistant to the controller, for example) compare the statements with the receivables trial balance and mail them.

5. *Cash Controls.* Controls over cash receipts have been described in the preceding chapter. An essential feature of such controls is to have present, at the source, a mechanical device that is directly under the jurisdiction of the controller, and that will act

as a safeguard against incorrect amounts of cash turned over to the cashier or banked by the cashier. Such devices include cash registers in which the amount of the receipt is recorded on a tape to which the cashier does not have access; strict control over and accounting for numbered sales slips; a ticket-taker who mutilates tickets in the presence of the purchaser so that they may not be resold; charges of merchandise at retail to branches, so that a total amount must be accounted for in the form of cash or merchandise on hand. Those who in any way touch or have access to cash should have no access to the control devices, or to the readings or records made up from them.

6. *Returns and Allowances.* Credits for customers' returns and allowances should be the responsibility of a major officer of the business such as the treasurer or sales manager—that is, one who has no direct contact with cash (the treasurer himself usually has no such contact). Returns should be authorized for entry only after a receiving report has been made a part of the record.

7. *Bad debts.* Bad-debt write-offs may also be authorized by the treasurer or other officer, but they should always be finally approved by the president or other major officer acting under delegation of authority from the board of directors, or by the board itself.

A final step in the institution of internal controls over receivables has to do with internal-audit procedures. The internal auditor or, where there is no internal auditor, some person delegated by the controller should make frequent tests of the actual operation of the controls. These tests include personal observation of cash handling, noting how errors are disposed of, making sure that individuals who handle cash or cash controls have the necessary competence for and interest in their work, and that arm's-length relations, so necessary for the continued existence of these controls, are being adequately maintained and are operating smoothly.

Balance-Sheet Standards

The following items should be separately disclosed on the balance sheet:

Customers (usually no distinction is required as between notes and accounts)
Officers and employees (unless minor in amount and arising from ordinary merchandise transactions)
Noncurrent items (to be shown beneath current assets unless trade practice justifies their inclusion with ordinary customers' accounts, in which case the balance-sheet sidehead should show the amount thereof)
Installment accounts (to be shown separately with noncurrent portion indicated in sidehead)

Affiliated organizations (the classification as between current and noncurrent will depend on the proposed method of settlement)
Credit balances (to be shown as current liability, unless amounts are under 1 per cent of receivables classification to which they refer)

Reserves for bad debts, discounts, and so on, should be deducted on the face of the balance sheet from the related receivables or, if the receivables are shown net, the reserve amounts should be disclosed in the receivables sidehead.

Notes and accounts receivable discounted and not yet collected are contingent liabilities and should be disclosed under that balance-sheet caption or in a footnote; when overdue, they are current liabilities. The amount of accounts pledged as security for a loan should be brought out both in the receivable sidehead and in the sidehead that refers to the obligation.

Audit Procedure

1. Obtain list or tapes of accounts receivable; refoot tapes; procure list of notes receivable showing maker, date, maturity, interest rate, amount unpaid, past-due installments, accrued interest, nature and location of collateral. Test accuracy of totals and compare totals with ledger controls.

2. Where the information is readily available, classify receivables into such groups as ordinary customers, customers having extended credit, accounts with government agencies, installment customers, consignments, and conditional sales. Ascertain credit terms for each class and unusual credit terms allowed individual customers.

3. Post, where practicable, collections and any major noncash credits since year end to receivable lists as an aid in determining collectibility of accounts. Test for accuracy and nature of credits.

4. Scan control accounts and trace nonregular transactions through detail accounts.

5. Compare sales invoices and shipping records for the last two weeks of the year to make sure that the necessary distinction has been made between receivables and finished-stock inventory, that invoices have not been predated, and that billings have been made to recipients of shipments.

6. Establish "negative" circularization program for customers' accounts that reflect regularity of purchases and prompt payments; samples should be selected at random. Circularize "positively," where practicable, customers whose balances are 5 per cent or more of outstanding balances of any class, or whose balances include transactions substantially greater than customary in past months

or transactions unliquidated over a relatively long period. Circularize "positively" officers' and employees' accounts other than those arising from ordinary transactions and other nonrecurrent accounts of material character. Compare circularization letters with list of receivables, indicate on list the items circularized, make certain that transmittal envelope bears return address of auditor's firm and that enclosed envelope is addressed to the firm, and be responsible for mailing.

7. Compare notes by sampling against list; circularize another sampling; trace notes paid off since year end to bank, and trace disposition of collateral.

8. Note on list the replies from circularization received by the auditor, and the action taken, if any.

9. Review interest received on notes during periods covered by cash audit; test interest accrued; and test total interest received for over-all accuracy.

10. Obtain confirmation on notes discounted, contingent liability thereon, and the particulars of discount agreement.

11. Obtain client's aging of accounts and most recent report of credit manager; test for accuracy; review credit policy, age-groups, and representative individual accounts with credit manager and note any trend or change in policy since last examination; compare credit manager's opinion of collectibility a year ago with actual collections.

12. Determine meaning of credit balances; if total is significant, classify as current liability.

13. Review client's estimate of reserve requirements; compare last year's estimate against experience; look for major modifications in condition of market, nature of product, rate of returns, and character of customers.

CHAPTER VIII

Inventories

The word "inventory" refers to the physical assets of a business which are held (a) for sale (finished goods and repair parts therefor), (b) for fabricating operations that will convert them into merchantable products (finished parts and raw or direct materials), and (c) for service operations (supplies or indirect materials). The auditor's interest in inventories is to make sure that each item is backed up by physical goods priced at costs that can fairly be expected to be recoverable in the future. He accomplishes this by observations of counts, studies of procedures, and tests for completeness, prices, and clerical accuracy.

Where perpetual records are competently maintained, the auditor's principal observations, studies, and tests may be made at various times during the audit period rather than following the close of the period. In any event he must decide as early in the year as possible what his audit program for inventories is to cover, and he must review the scope of his proposed inquiries with his client so that his work may be coördinated closely with operating plans. The auditor must always be vigorous in his espousal of adequate controls over inventories and in the institution of physical-inventory tests that conform to a carefully conceived internal program that extends throughout the year.

Book Inventories

Wherever possible, the auditor should encourage the installation and careful maintenance of book-inventory controls. For most purposes, the recording of only physical quantities is sufficient. They should be kept as a rule under the direction of the storekeeper, with a functional line of authority extending from the person who keeps the records to the controller. Internal-audit procedures should call for a verification of the book quantities with the physical at least once yearly, differences being subject to review and disposition by higher authority. Where the number and importance of the items warrant, one or more inventory crews may be employed on a full-time basis. They will not only make the necessary counts and comparisons but the investigations required in order to account for the errors discovered.

The auditor may accept a book inventory, provided periodic tests with physical quantities are regularly made and provided the differences thereby disclosed are not important. In every case, however, the auditor should direct and observe test counts of at least a few of the more important items, or the items, at any time during the year under review, that experience indicates are more likely to be in error. He should also ascertain the nature of any internal-audit procedures and reports relating to book inventories during the period covered by the audit and discuss any outstanding differences or problems with the storekeeper, stores-record clerk, and the controller.

If dollar amounts appear in the stores records, a listing of quantities will not be necessary at the year end.

Physical Inventories

The most important feature of a physical inventory is a carefully drawn plan under the provisions of which the count, the pricing, and the extensions and footings are made. A well-laid plan, skillfully administered, not only saves much work by the auditor but justifies his confidence in the totals finally arrived at. The plan, even in a small enterprise, should be in writing, and the auditor should review it while it is still in the draft stage, adding his suggestions wherever necessary. Points that should be included will be similar to the following:

1. General responsibility for inventory—one individual should be chosen who will carry out the inventory plan and who will be given commensurate authority, including the supervision of any special in-and-out count between the inventory date and the year end.

2. Dates, including close-down dates, on which the inventory or various sections thereof are to be taken. These may often be arranged to coincide with the time the auditor will be available—possibly a month or more before the end of the year.

3. Quantity controls, if not already in existence, should be devised whereby additions and subtractions can be made between the inventory date and the year end.

4. Sorting of stock—it is usually necessary to plan for the sorting and rearrangement, in piles or other orderly form, of materials and supplies, especially those items not in the storeroom, wherever the count will thereby be facilitated.

5. Training of employees—crews must be organized and instructed so that there will be no loss of time when the counting and listing process begins. They must be told precisely what to put on paper, and in some instances it will be necessary to familiar-

ize them with the stock they are to count. It is generally preferable to assign counters and checkers to stocks with which they are already familiar.

6. Last year's defects—defects in last year's physical-inventory procedures should be borne in mind when this year's procedures are written in order that whatever mistakes were made last year will not be repeated.

7. Work in process—where possible, plans should be laid to clean up work in process, particularly delayed or abandoned work, and, for active in-process items, to develop temporary cost-collection sheets for individual items or lots if job or work orders cannot be readily identified with physical work.

8. Items of same type—if the possibility of double counting exists with respect to items of the same type, arrangements should be made to count them all simultaneously.

9. Locations of inventory—floor plans should be prepared showing the location of the various classes of items to be inventoried; subsequently, the numbers of tags and sheets assigned to each location may be shown on such plans.

10. Forms—the forms and precise function and use of inventory tags and sheets should be described in detail so that their printing, numbering, distribution, filling in, collection, and summarization may be clearly understood by all inventory workers. Once printed and numbered they should be kept under strict control, subject to test by the auditor, carefully allotted to locations and individuals, and each accounted for when the inventory count has been completed.

11. Condition—defects, age, and other comments on the condition of inventory items should be regarded as an essential part of every count and noted on the tag or sheet as the count is made. A coding may be provided to show condition.

12. Two independent counts—where no stockroom quantity records are mentioned, the best procedure is to provide for two separate and unrelated counts. One method is to have tags made in two sections, each bearing the tag number. The tag is attached to the item, bin, or pile by the first counter, who fills in the lower, detachable section. Subsequently, the lower section is removed by an employee who makes sure that tags have been attached to all items. The top section of the tag is filled in by a second counter, and collected by another employee who also notes the completeness of the attachments. Other employees match the two sections and trace differences. A *single* count is usually adequate where stockroom records have been kept. The auditor should test a representative number of tag matchings, or matchings with

inventory accounts, and the competence with which differences have been disposed of.

13. Duplicates—where counts are transcribed directly during the calling operation to inventory sheets, the same degree of control should be exercised over their issue as that surrounding tags. In addition, the auditor may ask that they be prepared in duplicate, in which event he will hold the duplicate copies until the originals have been priced, extended, footed, and summarized (which may be several weeks later). By this device he is assured that inventory items and quantities are not modified except as changes are revealed by comparing the duplicates with the completed originals. With respect to quantities, his main job will then be to test the propriety of additions, reductions, or changes made since the joint preparation of both copies.

14. Cut-off on receipts—a part of the physical inventories will be items found on the balance-sheet date in the receiving room, and in trucks or freight cars yet to be unloaded. The inventory procedure should provide that these items be included in the count on that date, one procedure being to give them distinctive labels. When the date of count precedes the balance-sheet date and additions and subtractions are to be expressed only in dollar amounts rather than in item quantities, it may be necessary to follow the same procedure on the date of count also. To facilitate the count in the shipping room, the instructions may call for closing the shipping room for several hours.

15. Accounts payable—a search for and listing of receiving reports, for the period under audit, not yet matched with recorded invoices should be called for by the inventory procedures. The auditor will examine the work actually done under such procedures and test the results. He will also attempt to find whether any items have been received on which no receiving report has as yet been issued.

16. In-transit purchases—although not strictly a part of the physical-inventory process, the procedures should call for the building up of a figure for purchases in transit and, to avoid duplication, a comparison of supporting details with items recorded as being on hand. In some cases a satisfactory solution to this problem is found by comparing the dates appearing on receiving tickets for the first few weeks of the next following fiscal period with the shipment dates appearing on suppliers' invoices. It is always better practice to include in-transit items in the inventory, although some accountants take the position that this is unnecessary where in-transit items (a) are nominal in volume, year after year, and (b) relate to normal amounts of recurrent purchases.

17. Cut-off on sales—of no less importance is the cut-off procedure that must be established for sales. This usually involves the closing down of the shipping room for the final hours of the last day of the year, everything in the shipping room at that time being regarded as inventory. The date of shipment appearing on the retained copy of the invoice, as well as the date of the invoice itself, will ordinarily give a satisfactory clue to the auditor, provided he is satisfied with the internal control that safeguards the accuracy of these dates.

18. Inventory belonging to others—provision should be made for an internal procedure that will develop an accurate list of materials and finished goods in the hands of others but not sold to them; and, in contrast, a list of items on hand that are on consignment or on approval from others. In a few instances it will be found that sales to others have been made for which shipment has not yet taken place; agreements with customers will provide for storing them at the convenience of the customer. The first of these three classes of items should be included in the client's inventory, with due allowance for possible recovery (which may be small if samples or display goods are involved); the second class should be excluded from the inventory, and the third class also, provided the customer has been billed.

Cost

Inventories, like other assets, should be priced at their original cost, or, as pointed out in Chapter IV, such portion thereof, often measured by market price, as may be regarded as "reasonably applicable to future operations." However, the fungible character of inventory items, variations in cost-accounting methods, and the individual judgments that enter into determinations of what costs ought to be carried forward create many different patterns of valuation. The auditor should be familiar with the general characteristics of these patterns, for in each practical situation he must be able to develop opinions of valuation propriety.

The cost of purchased materials, parts, and merchandise is invoice cost, plus transportation, duty, and other direct purchase costs, less discounts and allowances, the former including trade discounts and cash discounts exceeding 2 per cent, but not always cash discounts of 2 per cent or less. Most accountants prefer to see prices net of *all* discounts, but the idea persists that cash discounts of 2 per cent or less are in the nature of interest and should, therefore, be regarded as belonging to the same category as interest received. Since discounts received are credits, any resemblance to interest must arise from the notion of *prepayment*—that is, payment before the "net" date. Terms of "2 per cent

10 days, net 30" mean that if the interest concept is adhered to, the 2 per cent discount relates to the period lying between the 10th and 30th days, which is 1/18 of a year—an implied "interest" rate of 36 per cent a year. The current rate of interest is too small a portion of this amount to separate. Nevertheless, where the custom is to regard cash discounts as income, the auditor rarely objects because the amount is small and consistency between years cancels the effect on the income statement.

At this point it might be well to review the notion of "consistency" since the word is often employed in attempts to justify doubtful practices relating to overlapping items. The omission of inventories altogether from financial statements would have no effect on net profit, provided, and only provided, that the dollar amount thereof remained constant over the years. The same is true of accounts payable for purchases and of expense accruals. But the proviso is all-important. The quantity of the inventory of every business enterprise *does* fluctuate, usually in a substantial way, and so does the dollar amount of payables and accrued expense. Further, without these items the current solvency—revealed by the balance sheet—would not be disclosed. However, with regard to small items, the failure to record them or to allocate them between accounting periods will not affect anyone's conclusions as to operating results or financial position, and the public accountant hesitates to insist on a strict application of conventional rules to such items. His justification for relaxation must rest on the smallness of the possible fluctuation over the years and of the smallness of any one item and of the total of all other excepted items, in relation to financial position at any one time. Regardless of the size of the amount involved, he should press for the future observance of correct practices, lest the infection of laxity spread to other, more material, accounts.

The cost price to be applied to the units of materials remaining at the end of a fiscal year may not be their individual costs even though the units may be identified beyond a doubt with particular purchase transactions. The fungible or interchangeable nature of most purchased items, particularly those of the average manufacturing enterprise, gives rise to six distinct types of cost the use of any or all of which is recognized by many accountants as valid in inventory valuations:

Basis	*Principal assumption*
Actual	Cost relates to specific items
First-in-first-out (Fifo)	Oldest acquisitions are disposed of first, which usually is in agreement with actual fact

Last-in-first-out (Lifo) and base-stock	Recent acquisitions are most nearly related to the prices at which sales are made
Average	Easily determined. People think in terms of averages. More consistency exists between inventory and cost-of-sales bases
Standard	More often applied to work in process and finished stock. Resembles average cost, except that unusual costs are excluded
Retail	Also resembles average cost, but results in less than average cost because of markdowns. Easily computed. Provides for normal margins on future sales

Because of the growing use of the last-in-first-out (Lifo) method, the auditor should be familiar with the arguments for and against it. Those who favor it claim that it more nearly reflects the operating point of view, whether or not selling prices are affected, since operating people are inclined to think in terms of margins between current market prices—wholesale and retail, or raw material and intermediate or finished product. The effect during a period of rising prices is to keep the cost of the inventory at a "safer" lower level than current replacement cost, thus reducing margins and making it possible to decrease selling prices, when the market swings in the other direction, without having to provide for inventory losses. If inventory quantities tend to be constant and inventory costs are kept at the lowest point in a long-range price cycle, the "Lifo" method of costing inventories becomes the "base-stock" method.

The "Lifo" method is advocated principally within the metal industries and others where the ratio of inventory to sales is relatively large. It is not suited to enterprises where inventory stocks are small or variable, turnover is rapid, or hedging operations protect future sales. It has the effect of creating a secret reserve, and it does not obviate the need in many instances of reducing cost to an amount not exceeding market.

Any consideration of cost, in the case of fabricated and semi-fabricated products, involves an intimate knowledge of operations and of the internal controls over operations, as has already been

observed in Chapter V. In most situations the inventory at the end of the year is much less, perhaps only a fraction, of the year's production, and the costing of sales and inventory is a joint problem. Where, however, the ratio of the cost, assigned to the inventory, to the year's gross margin is significant, which is usually the case, a good deal of importance attaches to the distinctions between normal and exceptional production costs, the natural tendency being to exclude the latter from the inventory and load it, sometimes as an extraordinary item, on operations. Among cost-determination problems of finished and partly finished goods that the auditor must consider are the following:

1. How costs of work-in-process and finished-stock inventories have been computed in past years; how estimates of items sold and on hand have been made during the current year in budgets and monthly statements and for other purposes. These computations may point to excluded costs which may deserve consideration in the present year-end valuation.
2. Tie-in of costs with accounts. The inventory valuation may be a residual cost, rather than a figure representing a control over specific details in a stockroom record. Where the latter exists, there should be frequent tests for the accuracy of the control in the general ledger. It is more usual to find controls over quantities than over both quantities and costs.
3. Method of determining costs carried into inventory accounts. The accuracy of these costs, particularly with respect to material and labor content will depend on the method of compiling the details—whether it be done by using standard or other estimated costs, how variances are disposed of, how long present estimates have been in use, and changes made in estimates to reflect changes in material costs and labor rates.
4. Worth of cost system. The auditor must make a practical appraisal of the cost system in use. This he will have done if he has pursued well his operational inquiries into production activities as outlined on pp. 58-60 of Chapter V.
5. Exceptional or abnormal costs excluded from the inventory-cost base. These will consist of such items as costs of shutdowns not anticipated, costs during a major conversion from one method or line of production to another, inefficiencies that have resulted in rejects or wastage not attributable to normal operations, or other costs which are of the type that are customarily written off as they are incurred.
6. Overhead and its distribution. Factory overhead should be justified against costs included under the same head in previous years, should contain no administrative or selling expense, and should be distributed on some reasonable basis.

Market

By "market," as the term is usually employed in inventory-valuation processes, is meant that portion of inventory cost that can justifiably be carried forward to future periods as the result of giving weight to price and other conditions likely to accompany disposal. It may be equal in amount to a price quotation on the balance-sheet date, a quoted price less the cost of selling and less a hoped-for profit, or some other cost fraction that experience has indicated as a "safe" base for application against estimated realization.

The auditor does not as a rule encourage the reduction of cost to a market figure for that portion of the inventory that will remain in the business as a minimum quantity to be kept on hand, or where the selling price has not yet reacted to a reduction in raw-material cost. Raw material that has been purchased in connection with the manufacture of a product for which a firm price exists and on which a normal profit is expected should never be marked down despite a lower market.

Market price in the case of work in process and finished stock is usually conceived to be the lower of (a) the cost of replacement or (b) the selling price less the cost to complete, selling expense, and the customary gross margin.

A market quotation should reflect the price on the balance-sheet date of a similar item, which would have to be paid in the area in which the purchase would ordinarily be made for the same quantity usually acquired at one time. Market prices are ordinarily applied to individual items rather than groups or classes, and when once a market price has been adopted in an inventory valuation, it remains as the cost for all future reckoning.

Reductions of costs to amounts equal to market are often collected together in an inventory reserve. To justify the reserve as a valuation account rather than as a subdivision of earned surplus, details of reductions to market by individual items or groups should be available, and in the succeeding period the reserve should be adjusted as these items are disposed of.

Markdowns of cost because of age or surplus quantities may be regarded as equivalent to market reductions, since the purpose is to carry forward only those costs that may fairly be applied against future realizations. These markdowns are often accomplished by adopting a percentage scale whereby the cost of an item is progressively decreased, as it is continued in stock, until scrap value is reached. In the retail method of determining inventory cost, the same purpose is served by reducing the expected selling price by an average mark-up percentage.

In all these situations the auditor will accept cost reductions when they are made in accordance with the principles indicated, are justified by past experience or present facts, and are fairly applied to the inventory as a whole. If the methods adopted differ from those in use at the end of the previous fiscal period, the auditor is compelled, unless the effect is unimportant, to indicate the change in a footnote or in his certificate, together with the approximate effect in terms of dollars, in accordance with the practices described in Chapter XV.

Internal Controls

A number of internal controls to which the auditor must give his attention have been mentioned in preceding paragraphs and in Chapter V. In addition, the following points usually require the auditor's review:

1. To obtain balanced inventories—i.e., inventory quantities that are adequate, but no more than adequate, for uninterrupted, economical production—planned production is essential. Such planning will call for the scheduling of purchasing, the flow of material in and out of the storekeeper's hands, the timing of finished parts and subassemblies, controls over quality maintenance and defective work: all based on realistic sales estimates or contract delivery requirements prepared by the sales department. A production-control executive may be required in larger enterprises.

2. Physical housing for inventory items should be provided, wherever required, as a protection against theft, action of the elements, and inaccuracies in recording receipts and issues. In addition, custodians or storekeepers should be appointed who have the proper qualifications for their role in maintaining prescribed internal procedures surrounding stock controls.

3. Minimum and maximum quantities should be specified as control devices for storekeepers to whom the responsibility for maintaining balanced quantities has been assigned. The setting of quantity limits should, however, be the task of the planning unit, and changes during the year that will reflect increases or decreases in the production schedule should be looked for by the auditor.

4. Deliveries from storerooms should be made only upon specified authority, an authority that should emanate from as high a level as practicable. The authority in some instances may consist of approved bills of material following the adoption of production plans and the issuance of production orders. Deliveries of finished stock or merchandise should be the consequence of approved shipping orders.

5. Periodic reviews should be made, by qualified persons within

the client's organization, for the purpose of discovering and taking action on slow-moving, obsolete, and damaged stock. Because the quantities of certain stocks, such as repair parts, which must be kept available for both old and new styles of products in the hands of customers, cannot accurately be measured in advance, it is important that quantities on hand be regularly appraised for their sufficiency. Overstocks should be disposed of, and the production or purchase of needed additional parts should be initiated, using the best estimates obtainable of what the new requirements are likely to be and employing the most economical methods of procuring the desired quantities.

6. In the event old stocks are retained, formulas or other methods of reflecting conservative decreases in costs should be adopted for the guidance of the storekeeper or others who deal with price.

Balance-Sheet Standards

In the balance sheet, the basis of pricing the inventory should appear. A subdivision of the inventory, by types of items, should also be given; usually the classifications of finished goods, work in process, finished parts, supplies, and raw materials are sufficient. In-transit purchases should be included as should consignments also, but consignments from others should be excluded.

Supply inventories are often classified under prepaid expenses, but they are properly a current asset since they more nearly resemble raw materials. Construction materials in minor amounts may be included with raw materials; but if a major amount has been acquired for a future project, its classification under fixed assets may be warranted. Returnable containers are usually placed in the last-named category.

An inventory reserve made up of provisions that reduce the cost of specific inventory items or inventory classes to market or to some other disposable figure is a valuation account and on the balance sheet should be subtracted, without need for disclosing the amount, from the classes to which it is related. A reserve created in anticipation of a decline that is reflected neither in market prices nor physical condition is a reservation of earned surplus and should be so classified.

Audit Procedures

1. Plan inventory examination at beginning of audit year. Review last year's inventory program; recommend to client drafting by staff of inventory instructions covering both perpetual-inventory tests and one-time physical inventory for items not covered by quantity controls. Review draft and make suggestions

for improved procedures. Recommend, also, appointment of responsible employee to administer program.

2. Be present at inventory-taking. Review controls over issue of inventory tags and their recheck; compare and make note of variations in actual methods followed as revealed by personal observation and through conversations with individuals participating in count. Call immediately to the attention of the supervising official any infractions of rules. Select items in each class for test recounts and for reconciliation with controlling records, if any, showing adjustments in controls and details; determine causes for material differences; compare with differences of prior years. Describe remedies instituted or proposed for reducing future differences.

3. Where physical count has been incomplete or none was made near year end for all or substantially all the inventory, and reliance is had on quantity controls, ascertain adequacy of interim counts and prepare a memorandum thereon for the working papers. Determine possible ranges of error based on past differences between book and physical inventories; select items in each class covered by quantity controls for test-counts, reconcile with book records, and, where possible, scan recorded additions and deductions since year end. If test-counts during year were not properly supervised, were not frequently enough repeated, did not cover substantially all items, or often disclosed substantial differences with book controls, it may be necessary to qualify the inventory item on the balance sheet or in the report.

4. Become familiar with location of inventory, discover from what sources and how item quantities and descriptions were entered and checked back for accuracy, how prices were determined and inserted, the conditions under which extensions and footings were made and subsequently verified, how page totals were classified and summarized, and establish the identities of the persons responsible. Verify representative extensions and footings and scan bulk of remaining inventory pages for extensions and footings.

5. Prepare a comparative summary of the inventory at the present and two preceding year ends, somewhat as follows:

INVENTORY SUMMARY

Class of Items	Type of Count	Unit of Count	Location	Pricing Method	Amount		
					This Year	1 Year Ago	2 Years Ago

List, in spaces provided, the different classes of inventory (e.g., raw materials or some subdivision of raw materials), divided, where

possible, by types of count (physical, book, bin record, lot record, warehouse receipt or other outside certification), units of count (items, containers, unit of weight or measure), locations, and methods of pricing.

6. Review cut-off controls applied to purchased materials and parts, finished products sold, and in-transit items; trace selected receiving reports and shipping records during three work days preceding and following the year end to recorded obligations and receivables, and, for the same period, trace back samples of recorded purchases and sales to records of receipt and shipment.

7. Select individual items under jurisdiction of as many departments as possible for turnover study; prepare three-year turnover ratios for these items, determine number of months' supply at year end, and reasonableness of each supply and of minimum and maximum controls in effect.

8. Study over-all inventory characteristics and trends within the business and the market generally; prepare a brief statement on causes of inventory variations between years, as revealed by the comparative summary; tie in with analysis of sales trends; compute comparative ratios to sales for each of the three years and for the final quarter and final month of each year.

9. Investigate the possibility of inclusion in the inventory of materials and parts owned by others, or consigned.

10. Request written confirmation of warehouse stocks and of material consignments to others, addressed to auditor, showing quantity, condition, and, in the case of warehouse stocks, liens and conditions of withdrawal.

11. Make sure that no "deadwood" remains in work in process and that production orders remaining are being worked on or will presently be worked on.

12. Look for maintenance, repair, and other expense orders in work in process, and see to it that they are cleared to expense, regardless of the state of completion of the order.

13. List, on inventory summary, pricing method followed for each inventory section:

If "invoice" cost, indicate elements included;

If work in process, or finished stock, indicate whether book cost has been followed or cost derived from physical survey, and describe basis for including materials, labor, and overhead;

If market, show source of quotation and cost;

If obsolete or slow-moving stock, compare sample items (quantity and price) with past years' inclusions, and indicate basis of pricing.

Test individual prices of each class and each inventory section, in

such a manner as to cover a substantial portion of the whole inventory.

14. Investigate outstanding purchase commitments at year end and ascertain possible liability for items exceeding ordinary contractual practices. If no list is available, examine open purchase-order and contract file for such items at audit date and review, very generally, major acquisitions and cancellations since year-end.

CHAPTER IX

Investments; Deferred Charges; Intangibles

Long-term equities of one corporation in another, whether in the form of bonds or stock, and whether involving majority or minority voting rights, or temporary or permanent interests, are referred to very generally as securities—or, in the hands of owners, as investments. Their ready marketability may classify them as a current asset, but the better practice is to exclude them from that category unless they are to be held only for a short period.

Valuation of Investments

For short-term holdings, the cost-or-less principle is applied. Cost for most investments will be the amount paid, including commissions and taxes on acquisition. Securities received in split-ups, reorganizations, and other noncash transactions may require prorations of original cost. In current practice, a less-than-cost valuation is justified for a short-term investment when, at the year end, the quoted market price (i.e., the closing price on any of the public exchanges, less selling commission and sales taxes, if significant), or other measure of current worth, has fallen below cost.

Long-term investments are carried at cost on the theory that temporary fluctuations are not related to the reason for continued ownership. But where there appears to be a permanent decline in worth, the auditor will urge its recognition by a write-down of cost, to book value if no other value determinant is available.

Bonds may be purchased at a premium or discount which is best amortized over the remaining life of the bonds on a straight-line basis. No objection should be raised, however, to a recoverable-cost basis, unless the amortizable amount is material to the balance sheet or income statement, which is not often the case.

In recent years there has been a growing feeling among accountants that entries on the books of a transferor of property—where the transfer is not an everyday commercial transaction—may be of significance as a measure in establishing "value" on the books of the transferee. This significance is evidenced by the practice recommended by many accountants that a stock dividend (except

for a dividend in common stock issued to common stockholders) be recorded (a) by the issuing corporation as a charge against earned surplus in an amount equal to the *higher* of (1) the equivalent average paid-in capital already attaching to shares of the same class, or (2) market value of the new shares issued, and (b) by the recipient as a credit to income in the same amount. A dividend of common stock to the holders of common stock needs no cost or "value" recognition on the books of either issuer or receiver since there has been no switch of book equities as between classes of stockholders; recipients simply have a lower cost per share, and the transaction differs from a split-up only in name. Although no suggestion has as yet been made regarding the issue, sale, and exercise of stock rights, an analogous treatment would require that they be recorded at their market price by both issuer and receiver, as a charge to earned surplus and a credit to income, respectively. Another illustration may be found in the suggested limitation of cash dividends as income, even where no affiliation exists, in an amount not in excess of surplus earned since the stock was acquired, any "unearned" distribution being regarded as a reduction of investment cost. In any of these cases the method of valuation should be disclosed in the annual statements if, by following any other method in current use, the remaining cost carried forward would be materially different.

Cost reduced to market or otherwise decreased, in recognition of value shrinkage, as in the case of an inventory item, becomes the new cost and the old cost may not be restored in a later period when the market value has risen.

When two or more lots of the same class of security have been acquired, the identity of any one share or bond becomes lost from the point of view of cost. Hence, average cost is preferably employed upon the disposal of less than the total of any one class. The "first-in-first-out" method is also in common use.

An auditor always takes the position that he is not an appraiser or valuer. This should not deter him, however, from seeking other evidence of value in testing the propriety of continuing to carry at cost securities for which no established market price exists. He may call for recent certified statements of issuers and review their financial position, operating results, and dividend-paying abilities with some member of the client's staff familiar with the situation. He may even examine the books or talk with issuers' officials. A large investment of this type may call for a valuation comment in the form of a balance-sheet footnote if doubt continues to exist in the auditor's mind as to the reasonableness of the cost or cost fraction at which the investment is carried.

Security Income and Expense

Income or expense arises from owned securities in the following situations:

1. Declaration of dividend or accrual of interest.
2. Occasionally dividends are paid in property or in some form other than cash. The rule is that "fair market value" must be assigned to the asset acquired, with a credit to income. If the asset received is liquidated in part, a corresponding portion of cost is expensed.
3. A dividend received is income of the current year, notwithstanding that the issuing corporation may have paid it from earnings of some prior year. As indicated above, the one possible limitation on its recognition as income is that it be paid from earnings since acquisition.
4. A dividend stock should be valued as outlined in a preceding paragraph.
5. When sold, the selling price of a security less its cost, or average cost if disposed of in part, is income that should be reported in the current income statement, although such income may actually be a realization of stored-up earnings over a period of years.
6. Following a reorganization or recapitalization, the exchange of old securities for new, plus, in some cases, the receipt of cash or other form of property, will give rise to income or expense, according to the valuation that is put on the new securities. The usual rule is to follow the Federal income-tax regulations in determining the gain or loss, since most of these rules are equitable and tend to set a standard known to many individuals.
7. An investment in an affiliated company is best treated like any other investment. Occasionally, the practice of taking up the undistributed earnings of a subsidiary or controlled company is encountered—a practice followed, for example, by E. I. du Pont de Nemours & Company, which owns a 22 per cent interest in the common stock of General Motors Corporation. Although General Motors is undoubtedly controlled by Du Pont, notwithstanding the minority holding, the practice is not a good one, for it permits earnings to be included in surplus (in the Du Pont case, its interest in General Motor's undistributed earnings is credited directly to a mixed surplus account): earnings that are reflected neither in the income statement nor in an increment in working capital.

Security Counts

It was noted in Chapter VI that under a well-organized plan of internal controls, the count of cash may be dispensed with. In

effect, the counting is done by the bank. Again, an inventory count may be *observed* by the auditor and he may direct test recounts. These principles are followed when the auditor satisfies himself as to the existence of investments. Where investments exist in quantity and change often, it is usually decided by the auditor to examine cash at the same time, since the interchangeability of cash and marketable securities creates a situation difficult to keep under control. The dual count need not be made on the final day of the period under audit; some auditors prefer that it be without prior notice. As in the case of inventories, the count may take place a month or two before the end of the period and the transactions thereafter kept under close scrutiny and control until the close of the year, at which time limited tests will suffice.

The first step by the auditor in a security count is to put all of the securities under his control until the count is completed. They can be brought together at one point and kept under his personal observation while the count is proceeding; if this is impracticable, the auditor secures in advance envelopes or boxes in which he and his assistants seal the securities handed them until they can be counted. The seals may be of wax or lead, and they may bear the auditor's imprint so that they cannot be tampered with without detection.

Lists of securities should always be prepared in advance of the count by the client's staff, the auditor prescribing the form and content. Columns should be provided for issuer, character of security, maturity date, number of shares or bonds, par value, if any, cost, market quotation, total market (or other) value, date of next coupon, and income received, with separate sheets or subheads for whatever classes of securities are to be shown on the balance sheet or in supporting schedules, for securities having no value, and for securities held in safekeeping or as security on accounts or notes receivable. Every security found to be on hand must be listed.

Where the securities are numerous, the auditor should have an assistant to whom the details examined may be called. It should always be borne in mind that no securities may be touched by the auditor except in the presence of a responsible official of the client's staff. Arrangements are often made whereby securities are handled only by the client's employees; the periodic examination of securities for internal-audit purposes may be arranged to coincide with the auditor's examination. In that event, the auditor sits beside the employee designated for the job of handling, and duplicate lists are checked off as the count proceeds.

All the details appearing on the list should be verified positively and precisely from observing the security itself. Thus, the "date of next coupon" that has been filled in in advance should be called out by the person handling the bond; at the same time it should be

noted whether all future coupons are attached. Other things to be observed are the name of the owner (except for coupon bonds), the corporate seal, and signatures of issuing officers (which are usually in facsimile if the security is listed) and of the registrar and transfer agent, if any, or of the trustee. Security numbers are not usually traced except where internal controls are poor and the auditor has reason for following up on individual transactions. A column is then added to the security-list form, which is filled in before the count, and ultimately the auditor traces the number to purchase-voucher attachments. The cost of securities in liquidation should be decreased by amounts already received—these will usually be indicated by endorsement on the security itself.

Where mortgages appear among the investments, the auditor examines supporting documents such as trust deeds, title policies or abstracts, and insurance policies. The nature of these supporting documents differs by communities; the authenticity of unfamiliar documents should be verified by counsel where their importance warrants.

Confirmations direct to the auditor should be procured for securities held by others, as collateral, pledged, or in safekeeping; securities loaned; and securities in a sinking fund or on deposit elsewhere for some special purpose. Confirmations should also be sought for balances due on securities in liquidation, long-term notes, or mortgages. In all these cases the possibility exists that payments have been diverted, or that credits have been allowed that have not been recorded.

Internal Controls

Before his security examination begins, the auditor should become acquainted with the investment *policy* of his client: why securities of certain types are purchased or otherwise acquired, what is to be purchased and when, how they are to be liquidated or held. Investment policies usually originate with the board of directors. The auditor should discuss with the management any nonobservance of such policies or conflicts with them.

Purchases and sales of securities should be made only under individual authorization or under general delegations of authority. If the purchase or sale price is not a quoted market price plus brokerage and taxes, detailed support for the price should be prepared at the time of purchase or sale and approved by the Board or management representative. Purchases from, or sales to, officers or stockholders should be prohibited. Sometimes the signature of two or more officers is required for each purchase or sale.

Records reflecting transactions in securities may be made in duplicate, as follows: one in the office of the treasurer or other

official primarily responsible as custodian; the other in the controller's office against which occasional tests may be made at the instance of either the controller or internal auditor. No fewer than two management representatives, no one subordinate to another, should be required to be present when safety-deposit boxes or other security repositories are visited. Income schedules should be prepared at the beginning of each year, with expected receipts and the dates thereof set down in advance; they should be maintained throughout the year in both offices and added to as dividends are declared or other distributions (as in liquidation) are announced. Notations of actual receipts may also be made on them.

Another desirable internal control is the examination of the list of investments and income therefrom toward the end of each year by the Finance Committee of the Board or by a management committee, to the end that investment transactions and year-end valuations be approved, and that income from sales and from interest and dividends be reviewed.

Financial-Statement Standards

The following statement practices should be observed by the auditor:

1. The basis of investment valuation should be indicated on the balance sheet, along with the total market value of quoted securities.
2. Securities should be divided on the balance sheet as between the principal classes of stocks and bonds, with industry subclasses, where their importance warrants. Investments in affiliated organizations should always be shown separately and clearly labeled.
3. The portion, if any, of securities pledged and the identity of the liability involved, should be shown on the balance sheet.
4. Income from securities, both gains and losses from sales and income from interest and dividends, should be subdivided on the income statement to correspond with the divisions and subdivisions of securities appearing in the balance sheet or exhibits attached to the balance sheet.
5. Advances to affiliates may be added, on the face of the balance sheet, to the investment account.
6. Where a consolidated balance sheet does not accompany the client's financial statements, financial statements of affiliates (combined statements of two or more affiliates are often practicable) should supplement any presentation of the client's financial position and operating results, provided their importance warrants.

Footnotes should call attention to intercompany transactions and the basis of their valuation.

Audit Procedures

The principal audit procedures have already been discussed; they may be briefly summarized as follows:

1. Obtain list of securities, prepared by client's staff.
2. Obtain certificate on securities pledged or in safekeeping at year end, and detail of transactions between year end and date of proposed count.
3. Count other securities, in presence of client's representative:
   a. Simultaneously with cash, where cash is counted; or
   b. At any time, where it is known that there have been no transactions during the year, or safety-deposit company's certificate is obtained, showing that there has been no opening of box since balance-sheet date.
4. Secure, where practicable, receipt on working-paper record of count.
5. Obtain or prepare analysis of security transactions for year, including income received or accrued therefrom, and:
   a. Compare opening items with last year's working papers;
   b. Verify principal changes during year, and dividends (by reference, wherever possible, to investment manuals), interest, and profit or loss from sales, earned or sustained during year, by reference to source documents and related accounts; and
   c. Compare closing items with security count.
6. Determine the reasons why securities held in the name of others have not been transferred to client.
7. Obtain market prices, if available, for on-hand items; and obtain and review financial statements relating to other investments.

Deferred Charges

The term "deferred charges" often heads up a section of the balance sheet, which may contain four classes of items: expenses, such as insurance and rent, commonly incurred by all business enterprise, that, although paid for during the current or some past period, relate directly to and benefit operations of the immediate future and ought to be (and sometimes are) classified as current assets; expenses incurred, such as franchises, licenses, or leaseholds, benefiting the future as do the items in the previous group,

but extending over a substantial period of time, and probably better classified as fixed assets; expenses, not yet paid for, such as unamortized bond discount—a debit valuation account that should be (but in practice only rarely is) subtracted on the face of the balance sheet from the obligation of which it is in reality the unaccumulated portion; and, finally, losses, as from a fire, which in certain classifications of accounts (e.g., that of the Federal Power Commission) are arbitrarily allocated against future operations, instead of being charged to expense, as they should be.

From a strictly accounting point of view, all these items are grouped together in error, and each deserves reclassification elsewhere; the practice continues, however, because of the force of habit and also, perhaps, because they are so often unimportant in their effects on the balance sheet and income statement.

Unexpired Insurance

A schedule of insurance policies in force during the year may be prepared for the auditor by the client's staff; they should be arranged by classes so that the total amount of each kind of insurance in force may be determined. There are many forms of insurance. In the average case, the auditor expects to find fire, tornado, use and occupancy, plate-glass, boiler, sprinkler, elevator, burglary, holdup, liability and compensation, and fidelity policies.

Important points to be watched in scanning policies are: (1) the ownership indicated, (2) the coverage, whether general or specific, both as to kinds of property and its location, and (3) the coinsurance clause. The coinsurance clause may be found in many policies, and from the auditor's viewpoint it is of significance in that, should a partial loss occur, the insurer stands only the same proportion of the loss as the insurance carried bears to the stated percentage (for instance, 80 or 90 per cent) of the cash value of the property. The cash value is generally defined as replacement cost new, less depreciation. If mutual fire-insurance companies are represented among the policies examined, the amount returnable in the form of a dividend should be estimated, using past experience or other information as a basis; the remainder is prorated, as is the entire premium in other cases.

Insurance policies covering the lives of various company officials may possess a cash surrender value, the amount of which may be ascertained by reference to the table contained in the policy, or, preferably, by confirmation from the insurer. Occasionally, this value is not carried on the books, the full credit being taken when the policy expires. The better practice is to record the increase on the books each year and to classify the accumu-

lated total under the noncurrent heading of investments, since it represents a tangible asset ultimately to be liquidated in cash.

Where an insurance register has been carefully maintained, the auditor may forego a list of policies for his working papers and test policies directly against the register. The register will ordinarily contain the policy number, name of the insurer, date and term of the policy, property insured, amount of insurance, premium paid, and amount of insurance expiring each year. The straight-line basis of premium amortization is invariably followed, although cancellation values are always much less. Where circumstances prevent the auditor from inspecting the policies, he may rely upon the information shown in the insurance register, together with a confirmation secured direct from the trustee or other holder.

Premiums for policies listed on the work-sheet or in the register should be tested against the insurance account to make certain that they have been paid for. A liability may exist for additional premiums on liability or compensation insurance, premiums on policies of this nature being based on estimates of the insured's payrolls. To determine whether such liability exists, the total payroll from the date of the policy to the close of the fiscal period may be multiplied by the rate shown in the policy; from this result the premiums already paid should be deducted. An overpayment of liability premiums may be carried forward as in the case of the portion of premiums paid to mutual companies that will be offset by dividends.

Officials and employees who have access to cash or other movable property, or who are otherwise in positions of trust, should be bonded in line with the client's policy; if they have not been so bonded, the attention of the responsible official should be directed to the omission.

The sufficiency of insurance carried should be discussed annually with the management.

Other Prepayments

Prepaid interest on notes payable is a misnomer. Like unamortized bond discount, prepaid interest is a debit valuation account, offsetting in part the par value of a liability on which something less than par was originally realized. It would be better practice if the "prepaid interest" were subtracted from the face of the obligation to which it is related.

From his list of notes payable the auditor may verify the amount of prepaid interest.

Rent paid in advance may be verified by an examination of the terms of the lease. Sometimes the lease demands the deposit of

a certain amount as a guarantee. This item, however, may be carried among miscellaneous receivables unless deductible from rental payments.

Nearly all taxes are in one sense prepayments of the protection and benefits conferred by government. Since these benefits accrue to all citizens and to all business enterprises alike and are of a character so unrelated to the expenses that a person or business voluntarily incurs, it has become preferred practice not to regard taxes as prepaid expenses at all; rather, they are accrued for the coming year as a current liability, representing, as they do, an inevitable diminution of working capital without the direct and tangible services that accompany prepayments. Nevertheless, it has been a long-established practice in many industrial concerns to treat most property and certain forms of excise taxes as prepaid expenses. Sometimes the period covered is specifically indicated on the tax schedule filed or the tax bill received. Where the practice is of long standing, the auditor will most likely follow precedent, the amount being small and the use of one method in preference to the other not seriously affecting working capital. If the item is permitted to stand as an asset, the portion deferred should be consistent with the nature of the tax, and the amount and period covered.

Where royalties covering mineral rights are prepaid, the contract between the parties should be examined in order to determine the correctness of the amount. Most royalty contracts call for minimum periodical payments, which may be in excess of actual royalties accrued, deductible from the excess of future royalties over minimum requirements. If the excess is not so deductible the royalties are in no sense prepaid.

Where the auditor finds organization expense on the books, he should analyze the account and ascertain the policy of the management in charging it off. Ordinary organization expense, consisting of legal fees, incorporation fees, and printing of certificates, is comparatively small in amount and if the company is at all successful the most conservative plan calls for writing off the entire amount the first year. Other companies, not so fortunate in the size of the expenditure or in their preliminary operations, will spread organization expense over a period of years. In those cases the auditor must ascertain expressed company policy and see that it is being properly followed. Occasionally, the auditor finds that the management desires to capitalize organization expenses permanently. Practical rather than theoretical objections interpose; the auditor will probably not permit the asset, if it be called such, to be merged with any other balance-sheet item, and standing

alone it becomes virtually an eyesore. No one future period derives any direct benefit or productive use from it, and it is an item that must frequently be explained.

Discount on capital stock should not be classified as an organization expense. It should be regarded as a valuation account, deductible from the par value of the stock to which it refers; or it may be charged against surplus, by action of the Board, as a quasi-dividend.

Bond Discount and Expense

Bonds are nearly always sold at a price that yields less than par to the issuer. The net yield involves the deduction from par of not only a discount to the purchaser but also legal, accounting, appraisal, and engineering fees and other costs necessarily connected with the issue. The simplest method of determining the annual expense is to divide the amount of the discount and expenses by the number of years the bonds will run. In the case of serial bonds the expenses should be allotted to the various years in proportion to the bonds outstanding during each year. Unamortized discount on bonds acquired before maturity should be subtracted from par in determining the gain or loss from a repurchase.

When a bond issue is refunded before its maturity and a new bond issue takes its place, the better procedure is to charge off the unamortized discount on the old issue as an extraordinary expense of the year of refunding. Some accountants prefer to carry forward the unamortized discount as part of the expense of the new issue, thereafter writing it off over the life of the new issue; other accountants would continue to amortize it at the same rate as that established before the refunding or at a somewhat more accelerated pace. These secondary methods simply have as their purpose the avoidance of recognizing the full amount of the loss in the year of its occurrence and the avoidance of what might otherwise be a "bad showing" for that year; they can thus be regarded as having no more validity than any procedure that seeks to omit expenses and losses from the income statement and to carry them forward as charges against future operations.

Audit Procedures

1. Prepare analysis of each deferred charge or prepaid expense for period, showing basis and determining propriety of accumulating and writing off costs; compare opening and closing balances with previous reports and current trial balance, respectively.
2. Establish propriety of deferment and amortization of uncommon deferred charges.

3. Examine insurance-register entries for year, test them against invoices, test accuracy of spreads, and prepare tape of year-end balances unexpired.

4. Scan insurance policies in effect at year end; note who, what, and how much is insured, and the significance of any special clauses; compare items outstanding with register.

5. Confirm by correspondence deposits on mutual policies, and the cash surrender value, if any, of life policies.

6. Compare unamortized and amortized long-term discount and expense in year-end trial balance with permanent-file schedule; verify adjustment for bonds retired during period; analyze any additions arising from new financing and prepare amortization schedule for permanent file.

Intangibles

Intangibles, sometimes given a fixed-asset classification, include goodwill, patents, trademarks and similar items; their valuation is usually represented as an attempt to reflect an earning power beyond that required for an investment in tangible assets. Intangibles are no longer as commonly found as they once were; most of them have been written off or are carried at nominal amounts. Often, the auditor finds that goodwill is no more than an excess of the par value of stock issued over the value that has been placed on a group of acquired assets, and that it is not the result of any precise calculation. Even where it has been established by purchase as representing the formal capitalization of a given number of years' excess of profits over a normal return, the accountant has frequently recommended, and with consistency, that it be written off by the purchaser during a similar number of years following its acquisition. It is now recognized that only in the rarest cases can purchased goodwill survive more than a few years. If, indeed, excess earning ability persists, its causes, more likely than not, cannot be attributed to the peculiarities of the business purchased, but to a situation that has arisen from wholly different sources. The excess earnings of almost any year may more justly be attributed to transient factors whose roots point to causes over which the business has little or no control.

The gradual extinction of goodwill over a period of ten or fifteen years, by provisions for its amortization charged against income, can thus be readily accepted by the auditor as a desirable and conservative practice.

Patent costs are now, as a standard practice, charged off as expense when they are incurred. At an earlier date, these costs, which often included experimental expense preceding the patent application, plus attorney's fees and often the expense of subse-

quent patent litigation, would be carefully capitalized, and then amortized over the patent life of 17 years. But the earning power of a patent, except in unusual cases, cannot usually be identified separately from earning power arising from many other factors. In any event, the cost that has been incurred on a patent bears no relation to what it does or should earn; and in many cases the expenditures that can be readily agreed to as the cost of the patent are wholly nominal in amount.

CHAPTER X

Fixed Assets; Depreciation

"Fixed Assets," "Property," "Plant and Equipment," "Property, Plant and Equipment," "Land, Buildings, Machinery and Equipment" are the captions commonly employed in published balance sheets to designate land and other assets that are held, not for sale, but for the services they contribute. The flow of services may apparently be permanent, as from land, or it may be limited to months, as from hand tools. Fixed-asset classifications generally include such items as containers and patterns, but exclude intangibles like goodwill and patents. The bulk of fixed assets are limited-life assets whose costs are accounted for as expense through provisions for depreciation. Commonly recognized broad subdivisions of fixed assets are land, buildings, machinery and equipment, tools, patterns and drawings, and furniture and fixtures.

In his survey of a manufacturer's fixed assets the auditor will have a more intelligent point of view if he has a background of the general layout of his client's plant, the character of the fabricating processes that go on within the plant, and a good knowledge of the types and adaptations of the machinery in everyday use. If he is able to recognize the principal operations that the machines are performing, a trip through the plant before his annual review of fixed-asset changes and factory operating costs will give him a better insight into the business than he would obtain from the most detailed audit. On a first visit to the plant, he should be accompanied by the plant superintendent or one of the company officers familiar with engineering processes. From such an official he should seek a summary account of plant operations, commencing with the foundry and continuing with metal forming, cutting, and boring, parts manufacture, and finally the assembling and inspection of the final product. He should ask questions concerning recent installations, machines that are standing idle or are regarded as standby, prospective changes in the plant such as building extensions or shutdowns, possible new machinery, changes in or modernizations of processes, and studies in progress that have as their object the lowering of costs or the improvement of the

product. If the auditor has seen the plant in previous years he will be able to make rough notes of changes, from observation and memory, or by requesting his guide to point them out as they proceed through the plant.

Although no one expects to find developed engineering talents in an auditor, a part of the auditor's academic training—or his private reading—should consist of a survey of the more important manufacturing processes. Books are available for this purpose, written for engineering students, shop foremen, and executives who desire to expand their operating horizons. The approach is primarily informative and nonmathematical, and from the text material and illustrations the auditor will very quickly acquire a good acquaintance with manufacturing phenomena. Particularly desirable is a knowledge of foundry practice, pattern work, metal casting, heat treatment and welding, and production machines and their setup, cutting tools, and measuring instruments. So equipped, the auditor will find himself much more competent to pass on fixed-asset additions, retirements, and improvements, maintenance problems, and rates and accumulations of depreciation.

Basic Valuation Problem

Because of the nature of fixed assets, and the frequent lack of internal controls over them, the auditor's responsibility varies from that which he assumes in the case of current assets. Plant ledgers, periodic physical inventories of fixed assets, and reviews of prospective usefulness by the management are not as common as they should be; the auditor's work is often limited to an examination of the propriety of the additions during the audit period, recorded retirements, and a lapsing schedule maintained for the purpose of removing from the depreciation computation, and often from the books, assets "fully" depreciated. Despite notable exceptions, business management as a whole does not yet fully recognize the need for the rigorous control of the figure for fixed assets that is projected into future operations.

The traditional valuation basis for fixed assets is cost—cash, or money's worth having objective substantiation, in a purchase or exchange with third persons. This basis is generally adhered to in a great majority of commercial transactions and is firmly established as an accounting principle. Questions often arise that involve the measure of "money's worth" and the definition of third persons, but the principle is almost universally supported. In the 1920's, appraisal values were often substituted for cost in the belief that the financial appearance of the business would thereby

be improved, but the continuance of depreciation based on cost as an operating expense was general. In the end the demand for consistency and, in the early 1930's, the general fall of prices and profits led to a reversion of appraisal values to cost. A few appraisal figures persist, however, and a few accountants remain who are willing to reintroduce appraisal values into financial statements. The subject is a broad one, but the main objections, with which the auditor should be acquainted, to enhanced figures for fixed assets are as follows:

1. Since the object of a business enterprise is to produce profits for stockholders, accounting procedures are premised on that basic notion. Thus the income statement ends with the net profit of stockholders and is transferred to earned surplus, which is a stockholders' account. Cost to the stockholder is what he (or his predecessor as a stockholder) originally contributed to the enterprise and an appraisal surplus that is neither contributed nor earned can have no meaning to him.

2. Borrowing power is rarely influenced by increased values resulting from appraisals. Established earning capacity and the prospect of its continuation, together with conservative financial management, are the major factors that attract borrowers.

3. The appraiser who determines amounts greater than cost labors under these two fatal handicaps: he must invariably produce enhanced values in order to justify his engagement; and, to support his computations, he must make assumptions that are thoroughly unrealistic and, as a rule, buried in a welter of figures and descriptions. These assumptions, if disclosed in a published financial statement, would prove to be more confusing than informative.

An appraisal that verifies costs or develops original costs is quite another matter. In the installation of a plant ledger the appraiser can also serve a most useful function.

Write-downs may be as objectionable as write-ups. In the mid-depression 1930's, reductions in fixed assets became very common and were inspired by the desire to rid the books of assets or values that had doubtful, or no, remaining worth. Often the decline could be attributed to plant or equipment disuse brought about by the depression; in some cases, they followed appraisals aimed at the carrying forward of only conceivably useful costs. In other instances write-downs were arbitrary and could not be allocated to specific assets, the aim often being to ease depreciation provisions for future years and thus achieve some degree of competitive advantage over business rivals. During the war many

plants were completely amortized as war facilities, despite the likelihood of their continued use after the war, because large profits were available and because the operating hazards in their postwar use loomed large.

In many medium-size enterprises the lack of stable fixed-asset-valuation policies has occasioned not a little misinterpretation of their financial statements. Aside from the fact that he must disclose the valuation methods employed, as outlined in a succeeding paragraph, the auditor must always be in a position to offer his advice on what a well-conceived fixed-asset-valuation program should be. His counsel against indiscriminate write-downs should, of course, be constructive but it should also be forthright. No loss of cost other than through the application of normal, well-established depreciation rates should be expressed on the books except under some such rules and conditions as the following: (a) the complete abandonment of a specific plant or other major fixed asset, evidenced by a plan for its disposition and by the consideration and approval of the plan by the board of directors; (b) the abandonment of a specific minor fixed asset, after a review of alternatives by a management committee reporting to the board; (c) the recognition of a partial loss of value of specific fixed assets, arising from construction premiums, excessive prices paid for materials or labor, the excess costs of a type of construction or capacity or other feature—that is, the extra outlay that can be justified for a particular emergency such as the recent war—provided the determination of the amount follows engineering or other objective, fact-finding studies and provided all such actions are reported to the board, leaving to the board the final determination of write-down of any major asset or of any large number of minor assets. Counsel of this nature by the auditor is warranted because any material disturbance in the customary recording, depreciation, or disposal of fixed assets is a financial matter of first rank to be decided on, not merely as the result of factual research but from the point of view of top business policy. The consequent discipline that this imposes on management adds measurably to internal controls, to the confidence with which the auditor can accept such decisions, and to the protection of investors from arbitrary and ill-considered decisions.

Where the standard of original cost has not been maintained and a write-up has been put in the books or a write-down has not been made under rules that the auditor can approve, a full disclosure should be made in financial statements of the basis followed, and the dollar amount of the effect of such basis on accrued depreciation and depreciation expense for the audit period should be footnoted.

Capitalizable Costs

A basic problem is the quantity of cost that may be permitted in fixed-asset accounts. The auditor must ascertain his client's definition of a unit of capital-asset expenditure, and the permissible costs that may attach to each such unit (a) when it is acquired, and (b) thereafter, during its useful life. Most accounting textbooks refer to the problem as one that involves the drawing of lines between "capital and revenue" expenditures—that is, the types of expenditure that should be capitalized (carried as an asset) as contrasted with those types that should be charged against operations.

On individual assets purchased, the standard of valuation practice is invoice cost, plus freight and installation, less all discounts. On assets constructed, the standard is the cost, less discounts, of material and parts, plus direct labor, plus, in some instances, overhead. The better practice on overhead is to include only the demonstrable overhead differential—that is, only the increments in the amounts of specific overhead accounts that can be positively attributed to construction. Salaries and other expenses of an engineering staff that has devoted its time exclusively to construction would be an addition to construction costs, either as a direct expense or as overhead. But the similar treatment of even a part of the expenses of a maintenance-supervisor's office that, in a brief interruption of its maintenance operations, has designed a new structure or a new machine is questionable. The preferred procedure is not to include in construction costs any such overhead except where obvious additional costs have been incurred because of the design or construction—and then only in an amount not exceeding such additional costs.

The acquisition of a fixed asset from an affiliated company, or design or construction work performed by one affiliated company for another, raises the question of the inclusion of both overhead and profit as a "cost." By "affiliated company" is meant a subsidiary or a company controlled by the same interests, as these terms are commonly employed in commercial practice and by regulatory bodies, including situations where minority stockholders' interests exist in either or both of the two companies involved. In commercial and utility enterprises alike, a leading reason for the formation and continuance of affiliated interests is to gain the economic advantages enjoyed by a single business organization. Deals between affiliates are never actually at arm's length; if they are made so, artificially, the very large economic advantage of low cost may be denied the ultimate recipient of the asset or the service that the asset supplies. Certainly, in the case

of public utilities, the public has the right to demand an accounting on a strict cost basis to the whole economic unit when rates are established. In commercial establishments the competitive advantages inherent in lower costs should lead to the exclusion of intercompany profit. The rule may be stated thus: on the sale of fixed assets to an affiliate, exclude profit; include overhead only on the basis approved for a single enterprise. The presence of a minority stockholders' interest will ordinarily not affect the general application of the rule; such an interest is rarely on the "selling" side of fixed-asset sales to affiliates, but if it is, and the loss of profit is material in amount, other financial devices are available whereby the minority stockholders may be compensated.

In practice, the rule is frequently not observed. The notion of the economic unit is obscured by the problems of separate managements and the often recognized need for a strong semblance of competition and arm's-length relationships between them. In any event, in the published financial statements of single affiliates or the economic unit, the basis of valuation must be clearly stated. Where any element of intercompany profit remains in the gross amount of the fixed assets, it too must be disclosed.

The amount of any lump-sum purchase of fixed assets that has not been separated into its elements should be disclosed in a footnote to the balance sheet, provided it is material. Not only is there the possibility that the item contains an intangible that should be excluded from the fixed-asset category, but the provision for and accumulation of depreciation thereon may be most inaccurate. The auditor, in every such case, should always strongly recommend to the management that the item be analyzed through a study of the records of the seller or by a cost study by engineers.

Reference to additions and improvements raises the question of fixed-asset "units." A "unit" refers to a carefully defined size or type of fixed-asset or expenditure relating to a fixed asset. Below the unit, no adjustment of a fixed-asset account occurs; above it, an adjustment is required. There may be units of capitalization, replacement, retirement, and accounting. A purchased building or a machine is a unit of capitalization; that is, either one is universally recognized as a fixed asset. A machine may be a unit for accounting purposes; or machinery, collectively, may be the unit, where there is no plant ledger. A building may be an accounting unit and its cost may be carried in the books without diminution until it is torn down or sold; or the cost of each building may be broken down into several replacement and depreciation units, such as foundation, wall, and roof. Depreciation at varying rates may be provided for these elements, or for depreciation-accounting purposes a composite rate may be applied to the

building's total cost. The cost of replacing a roof would be an expense if the retirement unit is the building; or an addition to the fixed asset if the roof is a retirement unit. In the latter case, the cost of the old roof would be a charge against the reserve for roof depreciation, or against the composite reserve for the building as a whole.

Minimum-dollar units are also common, the idea being to eliminate minor charges to fixed assets; charging small amounts to expense avoids "double handling" (i.e., capitalization and depreciation). Such a unit is commonly set for new assets as well as for additions, replacements, alterations, and improvements. Every hand tool and small machine may be capitalized, or only those above a certain dollar cost. The auditor finds that these limitations vary widely—$10 perhaps in a small enterprise and as much as $500 or $1000 in larger concerns.

It is difficult in any business to frame rules that will cover precisely all future work that may be performed on existing fixed assets. The general test for an addition to a fixed asset is that it must increase dimensions (e.g., a new wing on an old building) or productivity, or lower future operating costs (e.g., a gadget that will speed up an old machine or lengthen its useful life). Occasionally, certain types of expenditure, including exceptional maintenance costs, are charged against the reserve for depreciation, but the better practice today is to charge against depreciation reserves only the cost of units replaced or retired, consistently clearing costs affecting fixed assets through asset and expense accounts.

Because of these variations in the disposition of both old and new costs, and the need for consistency from year to year, the auditor should insist on the establishment and maintenance of a well-defined capitalization-and-retirement policy, accompanied by unit definitions. Such a policy is illustrated on page 132.

Internal Controls

Internal controls over fixed assets are poor in the great majority of business enterprises. One reason is that the accounting profession has not interested itself sufficiently in the subject—accounting literature dealing with fixed-asset controls is meager and incomplete. Another reason is that business management has likewise taken little interest; there is a general feeling that fixed assets, unlike current assets, cannot easily disappear and that depreciation provisions and accumulations are at best good guesses which are not made more accurate by elaborate records. The auditor is often prevented from making an adequate examination by reason of the lack of supporting records and competent studies by the management of depreciation-expense-and-reserve requirements. In

a first audit of a long-established concern, the auditor by custom assumes little responsibility for balances carried over from periods preceding his audit.

Internal-control standards for fixed assets have, however, shown marked improvements in recent years, and the auditor should lose no opportunity for recommending changes in procedures whenever he finds information inadequate. In this connection the auditor must always recall that accounting records for fixed assets—and for every other purpose as well—can be justified only to the extent that they will be put to intelligent use. A part of his job, in making such recommendations, will be to make certain that his client's staff will be instructed in the use of the new records, and that, at the top levels of management, conviction exists that the results sought are necessary to orderly business conduct.

There are several elements of fixed-asset internal controls of which the auditor should have a good working knowledge:

Plant Ledger. A plant ledger is of value to any enterprise, regardless of size. It may be difficult to install after years have passed without one, but the trouble experienced in getting it started and the small expense of maintaining it thereafter are repaid many times in more accurate costs, wiser planning, and safer internal controls. The most practicable plant-ledger standard involves the use of a card or sheet for each accounting unit on which appear such data as location, identification, date of purchase, invoice and other costs, reports of condition, and, after retirement, the cause thereof, and the amount realized from sale or scrap. When this information is written or punched on Keysort cards, the cards may serve as a detail ledger; after assets have been disposed of, the cards become the basis of retirement studies, invaluable in the setting of depreciation rates.

Unit definitions. When units have been carefully defined, as explained above, a more accurate and consistent treatment of fixed-asset charges is possible. Following are sample definitions, which may be applied to average situations:

1. Capitalization unit—an expenditure, in excess of $______, for a single fixed asset, or for an addition thereto that clearly has the effect of increasing physical dimensions or productivity, lengthening future life, or lowering future costs. In doubtful situations, the amount of an expenditure, if it is to be capitalized, must be well under either (a) the capitalized value of the resultant added service to be yielded, or (b) future costs saved.

2. Accounting, retirement, or replacement unit—a capitalization unit or the sum of two or more such units when they constitute a single physical item; or any replaceable part of a capitalization unit where the cost of the part exceeds $______. An accounting

unit usually coincides with a retirement or replacement unit, but it may also consist of several retirement units when it is a single structure; in that event it should be supported by a cost report from which the cost of each such retirement unit may be readily obtained.

3. Depreciation unit—buildings, factory machinery, small tools, patterns and dies, furniture and fixtures, automotive equipment.

In many cases it may be desirable to vary the definitions for each class of assets, particularly with respect to the test for capitalization.

Periodic reviews. As will be explained more fully under reserves for depreciation, an annual or other periodic checkup of fixed assets is a useful means of determining depreciation-reserve adequacy. The review may also serve to verify the existence and condition of each asset; comments on condition and estimates of remaining useful life may be entered on each card. A plan for the periodic verification of the existence and condition of each class of fixed assets is an essential element of every well-conceived plan of internal control.

Acquisition controls. In organizations whose financial operations are controlled through budgets, additions to fixed assets are usually planned far in advance of purchase. This may take such forms as lump-sum provisions for various departments, established at the beginning of each year, or detailed breakdowns with a description of each asset to be purchased. Regardless of the breakdown or even of the existence of a budget, it is common practice to have major specific fixed-asset purchases (e.g., above $1000) authorized by some management group, such as an equipment committee, which reports to the board of directors or the chief executive officer. Whatever the basic authority, the elements of control are: a review of the need for new equipment; the choice of contractor or manufacturer provided the need is agreed to; a decision as to price, installation, and other costs, and the method of financing; an authorization for the disposal, physically and in the accounts, of superseded equipment, together with the costs, past and prospective, that will be involved; and a review of the construction or purchase, including costs, after its completion. Decisions to contract or purchase are usually accompanied by some form of authorization such as a work order, and in the event of larger acquisitions or constructions a cost report is desirable as an aid to the equipment committee's review of the project; such a report should bring out the division of costs among the accounting units to be recognized and should give reasons for variations of detail or totals from original estimates. Dispositions of major fixed assets not accompanied by new acquisitions are often considered by the same

or a similar group: its records should reflect such details as reasons for the removal, the consideration of alternative methods of disposal, the selection of the highest bidder, the book cost and accumulated depreciation, and the treatment of remaining balances.

Whenever any one of these elements is missing or has been imperfectly applied, the auditor should recommend in specific terms the procedural improvements necessary to meet standards similar to those just outlined.

Tools and dies; patterns and drawings. Tools, dies, patterns, and drawings, even in a manufacturing establishment of moderate size, are numerous and almost always offer accounting difficulties. They may be kept on an "inventory" basis, with periodic physical counts at cost, or, where necessary, at estimated cost, to which the books are adjusted. Accrued depreciation may be estimated at the time the physical inventory is taken and the book reserve modified accordingly. Or, lapsing schedules may be set up on the basis of a composite average life of, say, five years, with annual reductions of the asset account for items depreciated throughout that period. A third variety of accounting may be to fix the asset account at a "basic" figure and to charge all additions thereafter to expense. Only in rare cases is this class of asset accounted for by perpetual-inventory methods. Occasionally, the auditor finds a resemblance to such methods in subaccounts, corresponding to models, that are eliminated when the models become obsolete. The most satisfactory form of internal control is a periodic inventory-and-depreciation study; and, between inventories, the capitalization of items exceeding in amount an established sum, and the accumulation of depreciation based, at least in part, on past experience. In any case, the auditor must satisfy himself on the following points: that the book figure of cost-less-depreciation for a period of years appears to be reasonably related to model life, changes in production, and volume of product manufactured, and that the management has followed a consistent practice in the application of accounting controls.

Maintenance and repairs. The relation of maintenance and repairs to fixed assets and to internal controls must always be borne in mind by the auditor. Like other expense accounts, a maintenance-and-repair account is rarely subjected to a detailed audit, but it must be carefully scanned. A primary object of the scanning is to test the accounting policy of capitalization—that is, if the policy is to capitalize items, say, in excess of $100, which meet the tests of adding productivity, lessening cost, or extending useful life, have any such items been charged to maintenance and repairs account? Other scanning objectives will be to compare the account with similar expenses in previous years and to spend some

time on larger items. Fluctuations as between years may be material, for the account is a variable, with wide limits, and it may reflect in one year fixed assets worked to capacity, and in another, idle time or a shutdown that has made major overhauls possible. The management of every enterprise knows the meaning of deferred maintenance—the putting off of repairs until a chance opportunity arises—and it can readily furnish the auditor with information on fluctuations between months of the current year and between years.

The same care that surrounds equipment purchases should be exercised over maintenance-and-repair operations. The equipment committee may supervise them and issue blanket work orders for ordinary repairs and special work orders for extraordinary or emergency repairs. In some instances, a separate department will be found, the head of which is a maintenance engineer who reports to the top executive of the organization; in others, the responsibility resides in the plant superintendent, with apparently no upper limit on expenditures. Obviously, these are widely varying practices. But present in all cases should be an agreed-upon delegation of maintenance-and-repair authority to some individual or organizational unit; work orders or their equivalent; estimates of costs, followed by studies of variations with actual costs; and an active interest, within the management, in maintaining low-cost levels already established or seeking cost levels lower than the present.

Maintenance reserves that have as their purpose the equalization of maintenance-and-repair expense as between years are occasionally found in practice. Combined depreciation-and-maintenance reserves also exist. They are subject to the same objection as other equalization reserves, and the amount of the reserve is almost invariably an arbitrary figure that is not the end product of studies of maintenance deferred. A blast-furnace relining reserve, often present in the accounts of steel producers, is usually more of a reserve for depreciation than for deferred maintenance, and it is preferably so treated on the balance sheet.

Balance-Sheet Standards

There are five principal balance-sheet standards that should be followed in presenting fixed assets:

1. The valuation basis should be shown. Where cost has been followed consistently, the fixed-asset sidehead may, for example, be "Plant and Equipment, at cost"; if, at an earlier date, an appraisal was introduced into the accounts the caption might read, "Plant and Equipment, at values determined by Messrs. Blank and Blank, appraisal engineers, as of November 15, 1928, plus additions since, at cost." If only depreciable assets were ap-

praised, then the point will, of course, be reached where such assets will have been wholly retired, at which time the appraisal reference may be eliminated.

2. Fixed-asset items that are out-of-use and are likely to remain in that status for an indefinite period should be separately stated, together with any accrued depreciation applicable to them.

3. A breakdown of fixed assets is usually unnecessary except for land and any other nondepreciable item included in that category; the purpose should be to disclose the depreciable base. It is preferable to disclose the amount of assets that have been subject to "tax amortization."

4. The amount of fully depreciated assets still in use, which by custom (e.g., such as that established by following a lapsing schedule too literally) have been eliminated from the balance-sheet figures, should be disclosed in a footnote. The better practice is to leave them in the balance-sheet figures until they have been disposed of, thus eliminating the need for the footnote.

5. Construction work in process, when material in amount, should appear as a separate item under the fixed-asset caption, and the amount of any material contractual obligation on future construction should also be revealed.

Disclosures of other types, made necessary by oddities of capitalization, valuation, or depreciation, are usually more satisfactorily conveyed to the reader when in the form of footnotes.

Audit Procedure

1. Obtain analysis of changes during audit period in fixed-asset accounts and tie in opening totals with previous year's papers and closing totals with current trial balance.

2. Review authorizations for bulk of plant additions during period.

3. Examine source documents supporting cost of additions; analyze and summarize main cost elements. Test material and labor costs of client's own construction and note basis for any overhead elements included. Examine cost reports, if any, and test accuracy of cost summary.

4. Analyze retirements, cost of removal, and resale or scrap credits. Ascertain what event determines the recognition of a retirement and how retirements have been disposed of in the accounts. Investigate possibility that fixed assets, in excess of requirements or obsolete or otherwise out of service, have not yet been recorded as retirements.

5. Review practices which have governed the capitalization and expensing of tools and dies and patterns and drawings, and review representative items capitalized and expensed.

6. Scan repair-and-maintenance accounts; summarize nature of charges therein and how they were made. Determine practice in disposing of costs of major overhauls, expenditures tending to "offset" depreciation and lengthen the life of an asset, and similar borderline costs.

7. Summarize any activities during the period directed toward an inventorying or verifying of existence or condition of fixed assets.

8. Ascertain whether any fixed asset not owned is on hand or has been in use during the period.

9. Look for restrictions on asset use in equipment-loan or other loan agreements, government contracts, and equipment leases, and determine whether such restrictions have been observed.

10. Examine any unfulfilled contracts for construction, and review with principal the need for disclosing contract balances in financial statements.

11. Review insurance policies on fixed assets with the view of determining whether policies in force conform to client's desired coverage of risks.

Depreciation

Depreciation is *expired utility*. It refers to part or all of the services that a limited-life asset will no longer yield, regardless of whether such services have actually been yielded, or if yielded, whether they have benefited production. Depreciation is commonly regarded as a function of use, but because it is also a function of disuse, maintenance, changes in production, and progress of the arts—interrelated and inseparable causes that are magnified by the age of the asset—it generally finds expression, in accounting, as a function of time. Thus, a machine wears out because of use and it wears out faster if it is used sixteen hours a day rather than eight. A machine that stands continuously idle also becomes potentially less and less useful as time goes on; in fact, certain machines age more speedily from disuse than from use. Again, from lack of maintenance or from unskilled maintenance, a machine will deteriorate rapidly. Or, if the productive process in which the machine is used is altered, the machine may not be adaptable to the change. And when new devices have been perfected and another machine is available that will perform the same operation more simply, more quickly, or more cheaply, a machine's future usefulness may be severely diminished. All of these factors are present to some extent in every manufacturing enterprise; but it should be recognized that they may be measured compositely more accurately than individually, not only because of their interrelated character, but also because the collective experience from which future estimates of usefulness are necessarily derived links depre-

ciation with periods of time. By the same token, the measurement of depreciation in a large group of fixed assets tends to be more accurate than the measurement of depreciation in a single asset.

Obsolescence means loss of usefulness occasioned by progress of the arts, or such other external causes as changes in consumer demand or legislation or regulation leading to the reduction of future production. Inadequacy is loss of usefulness brought about by business growth; a building or machine may have to be replaced because it cannot accommodate an increase in output. Since obsolescence and inadequacy relate to conditions common to all business, they are invariably included in normal provisions for and accumulations of depreciation. Where the advent of any of these factors is sudden and cannot reasonably be anticipated, the obsolescence or inadequacy is referred to as "extraordinary" and may be of such material amount as to require special provision in the accounts, and separate disclosure in the financial statements.

In everyday accounting usage the word "depreciation" may refer to any of the accounting calculations or accumulations that follow the recognition of expired utility. It is always best to couple the word with another in order to make the meaning clear—for example, "depreciation rate," "depreciation expense," "reserve for depreciation."

Basic Concepts

With the exception of land, every fixed asset has a limited life during which a quantity of services will be given off. Its cost, less whatever can be realized in the way of scrap, is a prepaid expense that must somehow be spread over its life. If the quantity of services is measurable, the following formula will give the periodic depreciation expense:

$$d = \frac{C - s}{Q} \times q, \tag{1}$$

where d is the depreciation expense for the period; C, original cost; s, original cost recoverable as scrap; Q, the estimated quantity of future services that will be yielded; and q, the actual quantity of services given off during the period. Only in the rarest instances, however, can the quantity of services of the ordinary fixed asset of a manufacturing enterprise be measured. For most fixed assets there is no recognized unit of service. However, the formula is basic for so-called wasting assets such as coal, timber, and other natural products, in which case d becomes depletion expense, Q, the estimate of tons, square feet, or barrels to be extracted, and q the number of such units currently extracted. But since Q varies

as new "proven" areas are developed under or on the land or lease of which C is the cost, a new rate may have to be established for the current year and the formula becomes:

$$d = \frac{C - s - R}{Q_1} \times q, \tag{2}$$

R being the balance of the depletion accumulated in and carried over from prior years, and Q_1 the estimate of quantities to be removed *in the current year* and future years. When rates (the fractions shown above) change, it is customary to include *all* of the year in which the change is made in the new computation, and not to alter accumulations of previous years. This is true of depreciation as well as depletion.

In ordinary depreciation accounting the simplest practice in determining annual depreciation expense is to apply a percentage rate to an asset group like "machinery," the formula being:

$$d = C \times \frac{1}{Y}, \tag{3}$$

where Y is the estimated average number of years the group of assets will be in use. The ratio $1/Y$, usually expressed as a percentage, is a composite rate—one that may have application to many items of the same kind and even to many enterprises. Thus, one of the commonest rates that may be found in all sorts of businesses, is the furniture-and-fixture rate of 10 per cent. As a *composite* rate, it has evolved from general experience with large groups of fixed assets; applied to a particular enterprise, it may prove more conventional than accurate. Auditors often find furniture and fixtures completely depreciated, with the assets still in use. Similarly, conventional rates are common for other classes of assets, and these, too, are usually found to be inaccurate when applied to individual enterprises, even though they may represent a reasonable average for the industry.

The above three formulas are so-called "straight-line" formulas, as are also the following two variants:

$$d = (C-s) \times \frac{1}{Y}, \quad (4) \qquad \text{and} \qquad d = (C-s-R) \times \frac{1}{Y_1}, \quad (5)$$

where R is the balance of depreciation accumulated in prior years, and Y_1 the estimated number of years of remaining life *including the current year*. Each of these variants has its advocates, but in

most instances they yield substantially the same results, notwithstanding their theoretical distinctions. Of the five formulas, (5) is probably the most accurate, provided its application can be accompanied by periodic remaining-life studies leading to the correction of Y_1.

A further variant arises from the use of lapsing schedules. This practice is commonly followed by Federal internal-revenue agents; it is essentially the application of formula (3) to each year's acquisitions, a separate schedule being prepared for each principal class of fixed assets.

Occasionally, the auditor encounters a plant ledger in which depreciation is accrued on individual assets. The back of the card maintained for each item may be used for the annual provision for depreciation and the total thus far provided; the sum of the accumulated provisions on all cards may agree with a general-ledger depreciation-reserve account. Many accountants believe this to be a desirable refinement of the methods previously described, provided formula (5) is applied to each item; statistically it offers no advantage over the results produced by the periodic application of formula (5) to an entire asset group.

Depreciation is often computed for fractional years on additions and retirements, an average of one-half year being assumed, or it may be computed down to the month or half-month. No objection can be raised to this procedure, but the auditor should be able to demonstrate that no statistical accuracy is added by fractional-year depreciation adjustments for any one period unless there have been major one-sided changes in fixed-asset accounts during such period—and that, even then, the effect on the balance sheet and income statement may be negligible.

Where depreciation reserves have been built up by the application of average rates to asset groups, retirements are best charged in full against the reserve, with exceptions only in the case of individual major assets that have been in use substantially less than the average life of that class, as reflected in the depreciation rate. A "major" asset might, for example, be defined here as one whose cost is greater than 20 per cent of the depreciation reserve applicable to that class of assets; a "substantially less" life might be one that does not exceed half of the average for that class. These are not meant as general standards but as useful sample tests that the auditor may prepare in discussing with his client the effects of varying procedures. A more common but less desirable practice statistically is to regard as current expense or income any variation between the original cost of an asset retired, less scrap value, and the proportional depreciation accrued during the years

an asset was in use. Assume that a machine, acquired in 1939 at a cost of $1000 and scrapped in 1946, belongs to a class against which an annual depreciation rate of 10 per cent has been applied. If a half-year basis is assumed for additions and retirements, or if the balance at the beginning of each calendar year is the basis for applying the depreciation rate, seven years' depreciation will have been accumulated. With a scrap-value allowance in each year's computation equal to 5 per cent of cost and with, say, an actual realization of $100 from the sale of the machine as scrap, the problem of classifying an "unrecovered" cost of $235 remains. Is this a charge against the reserve for depreciation on machinery, additional depreciation for the year, or a loss on the disposal of fixed assets? Preference is given to the first method because an average rate of depreciation will often result in apparent underprovisions for individual assets; but it will also result in apparent overprovisions in the case of assets in use for periods longer than the average, and the remaining cost of $235 will ordinarily be absorbed by such averages. The second method can be justified statistically if it can be demonstrated that the average rate of 10 per cent is too low for the class of assets as a whole, but usually such a demonstration is impossible unless a relatively large number of "premature" retirements have been experienced. The effect of this procedure is to modify the annual provision for depreciation above or below the average indicated by the rate, according to the net excess of "underprovisions" or "overprovisions," respectively. The third method, although often found in practice, should be confined to situations where a sale is made of an asset that, if not sold, would continue to yield useful services to the business. Classification in the third category often arises because of the failure to recognize the principle of averages involved in depreciation rates and reserves.

On the whole, the most desirable standard of depreciation practice is the use of a composite rate for each of the main fixed-asset groups; the charging of the full cost, less recoveries, of each asset retired to the reserve, except under conditions described above; and the periodic testing of reserve adequacy.

To test the propriety of an annual provision for depreciation an engineering survey may be made by examining each asset covered by the reserve and estimating its remaining years of useful life. A "book value" for each asset, consisting of original cost less accumulated depreciation at rates in force since its acquisition, is then determined and divided by the estimated years of remaining useful life. The sum of the quotients thus obtained, divided by the total original cost of the same asset group, will indicate the theoretical rate that should apply. The same basic data will also

serve in a test for reserve adequacy. A typical test appears in the Illustrative Audit, worksheet H-4.

Many auditors accept the practice of removing from the accounts costs of fixed assets shown by lapsing schedules to be wholly depreciated. This practice may be modified in instances where larger retirements are individually recorded, but the practice should be recognized as a much less desirable alternative to the full reporting and recording of each retired asset. A lapsing schedule is an exceedingly poor substitute for a plant ledger.

Internal Controls

Management attention to depreciation is often weakened by the unfortunate attitude that the annual provision for depreciation is at best a crude and arbitrary estimate—an estimate that has wide flexibility. This attitude leads occasionally to the manipulation of depreciation provisions in the interest of "making a showing"—decreasing provisions in years of poor profit margins and increasing them in good years. Attempts to modify the depreciation charge to correspond with units produced are not generally successful, as has already been noted. Nevertheless, where such an attempt is made, the auditor's acceptance of the result will be dependent upon his conviction that the altered rates have been arrived at after a careful study of such factors as actual use of assets, rates for normal years, the ability of normal and abnormal rates to absorb cost during useful life, and the effect of obsolescence and inadequacy on such rates (normally these factors are present and operate inexorably to shorten economic life, notwithstanding nonuse).

During the war period, several causes contributed to greatly accelerated accumulations of depreciation in corporate enterprise. High prices, established by government procurement agencies because they were deemed necessary to stimulate the production of the materials of war, led to substantial profits and the incentive to show increased costs as justification therefor. Accelerated depreciation, called amortization, was permitted under Federal income-tax laws, also as a stimulant to war production. The future utility of new plants, or old plants adapted to war production, was problematical. At the end of 1944, a review of the balance sheets of one hundred leading industrial corporations indicated that the ratio of depreciation reserves to fixed assets varied between 28 per cent and 86 per cent, with an average somewhat in excess of 50 per cent. These ratios will decrease as war plants are abandoned. Also, suggestions have been made that these ratios be revised downward by the transfer of "excess" depreciation to earned surplus. A plan better attuned to corporate responsibility

to the public, however, would be to follow the standard practice, already referred to in a preceding paragraph, for revising future depreciation charges. This preferred practice may be stated thus:

Where studies indicate that the recorded accrued depreciation of an asset or asset group is over- or understated, the current rate of depreciation should be so adjusted as to spread equitably any unrecovered cost over remaining useful life.

An exception might be made where, because of a management decision or other anticipated cause, obsolescence must be recognized in a substantial amount; in that event the resultant sudden increase in the depreciation reserve, or the write-down of remaining cost, may be important enough to be shown as a separate item in the income statement of the current period. But the auditor should take a firm stand against the restoration of depreciated costs. Costs, once recovered, should be forgotten. If adjustments *must* be made, they might better take the form of lowered prices to customers on the future output of the overdepreciated assets. To seek to recover the same cost twice would not only be bad accounting; but in the case of excessive depreciation accumulated during the war period it would conflict squarely with the public policy that gave rise to the higher prices or lower taxes that the owner of the assets enjoyed.

The auditor should always seek to keep the management policy controlling depreciation on an objective level, and to encourage periodic internal reviews of depreciation rates and reserve adequacy.

Financial-Statement Standards

In the income statement the amount of depreciation expense should be shown on the face of the statement or in a footnote. The amount of any amortization provided under permissive tax laws or of any other form of extraordinary depreciation or obsolescence should appear as a separate item.

Where depreciation expense for income-tax purposes differs from that appearing in the income statement by an amount greater than, say, 10 per cent of the latter or 5 per cent of the net income for the period, a footnote to the income statement should reveal the amount thereof.

Depreciation reserves on the balance sheet should be subtracted from the assets to which they relate. This practice is far more common than it used to be, but it is not yet universal. The principal exception may be found in public utilities, many of which are still not on a full "depreciation basis"—that is, their reserves cover only fairly immediate replacements and are classed with other re-

serves in the liability side of the statement. Reserves for amortization (the 20 per cent-per-annum reserves permitted under the Federal income tax) should appear as a separate item along with depreciation reserves, or the amount thereof may be disclosed in the depreciation-reserve sidehead. A practice of several companies is to subtract the provision for amortization directly from the assets concerned and show only the net figure on the balance sheet; but since amortization is simply rapid obsolescence and therefore a form of depreciation, there seems to be no good reason for this exceptional treatment.

Summary details of annual changes in fixed assets and depreciation reserves appear in schedule form, accompanying a few published financial statements. The practice is an excellent one and should be followed more generally.

Audit Procedure

1. Obtain or prepare analysis of changes during the audit period in each depreciation reserve; compare opening totals with previous year's papers, depreciation provisions with related expense accounts, charges to the reserves with the corresponding credits in the analysis of fixed-asset changes, and the closing balance with the current trial balance.

2. Review any engineering or statistical studies of depreciation rates made during the period.

3. Review method of computing depreciation and verify provisions for year. Ascertain reasons for any variation of rates or method of computation as compared with previous year. Compare rates used with "standard" rates.

4. Examine most recent report of Federal internal-revenue agent on depreciation, and if it is not in agreement with books, ascertain whether differences have been studied and note the results of any conferences with BIR representatives.

5. Where sales or other disposal credits appear in the reserve analysis, trace representative transactions from authorization to realization. Follow the same procedure for sales of fixed assets accounted for through profit and loss where the whole cost of the retirement has not been deducted from the reserve.

6. Compute percentage relationship of reserve balances with corresponding assets and, in adding summary data to permanent file, note percentage trends for past ten years. Discuss generally these trends and the depreciation problem with management charged with depreciation responsibility.

CHAPTER XI

Liabilities

No one term has been universally agreed upon as a caption for the right half of the balance sheet. "Equities" has been suggested but has proved unacceptable since its common, nontechnical usage implies an active ownership. "Liabilities and Net Worth" or "Liabilities and Capital" are frequently used but lack the force of a single word. "Liabilities" alone is often employed and perhaps deserves a wider acceptance; its derivation, from an ancient root meaning to "tie" or "bind," suggests that it may be accurately used as indicating *any* financial linkage with others, and a legal or moral responsibility as well.

Some auditors claim that they pay little attention to liabilities directly, their position being that if assets and expenses have been given the care they deserve, the correctness of liabilities follows as a matter of course. They may, for example, point to procedures surrounding the inventory cut-off—on the purchases side—as illustrating how an important section of current obligations has been derived, almost as a by-product, from the study of the inventory. However, an analysis of such a claim indicates that the question is one primarily of emphasis and timing, rather than coverage. What these auditors mean is that their examination of suppliers' accounts payable accompanies and is made a part of their examination of an asset. Yet the point is well worth mentioning, for it brings out one of the important developments during recent years in auditing procedures—that the annual audit is tending in the direction of a study of business procedures. In the illustration cited, the study begins, not with inventories, but with management policies, thence to the conduct of operations, purchases paid for and unpaid, the cost of materials used, and inventories. The sequence in the study is unimportant, because parts of these problems must be considered by the auditor at the same time. Their individual meanings, and the meanings of the accounts in which they are reflected, become clearer when they are studied together. They are simply different aspects of the larger problem of material flow, brought about by the artificial cleavage in that flow caused by the ending of a limited period of time. From this point of view,

the examination of either inventories or accounts payable to suppliers is integral with other elements in the over-all material picture that the auditor endeavors to draw.

Current liabilities are, by general agreement, obligations payable within a year after the balance-sheet date.

Notes Payable

In the typical request for information from banks, illustrated on page 74 of Chapter VI, space is provided for a listing by the bank of direct and indirect obligations, and the form is sent to every bank with which the board of directors has authorized the management to do business. From the information called for by the form and supplied by the bank the auditor will be able to verify the date the note was given, the net proceeds, the interest paid thereafter, and the accrued interest at the year end.

Occasionally, the auditor will find that a note has been given in settlement of an obligation, although the obligation continues to appear as an account payable. This possibility should be borne in mind when scanning the detail of outstanding accounts payable.

Because of the importance of notes payable, and because in ordinary situations they are few in number, the auditor should prepare (or have prepared for him by the client's staff) a schedule of notes that have been outstanding at any time during the year. It will commence with those reflected in last year's balance sheet and will show such details as date made, renewal date, due date, payee, nature of original transaction, amount, date and amount of payments, name of indorser, collateral held and dates given and returned, and dates and amounts of interest paid or accrued. From this schedule interest expense and accrued interest should be verified.

Confirmation by correspondence is a standard procedure for notes payable. Besides letters to the banks, letters should be addressed to every payee shown on the note schedule even though the records show that some or all of the notes have been paid. Information as to the amount outstanding and the collateral held at the year end should be called for. The letter may take the form shown on page 147.

Accounts Payable

Cut-off procedures relating to purchases have already been described (Chapter VIII, p. 101). Determination of purchases in transit should be followed by adjustments, adding to both inventories and payables.

The auditor should procure from his client a trial balance of accounts payable, consisting of a formal list of voucher numbers,

(Letterhead of client)

Staple Products Company,
15 N. LaSalle St.,
Chicago, Ill.

Gentlemen:

Please send to our auditors, Hyatt, Paterson & Co., 960 Hudson Bldg., Chicago, a statement on the bottom half of this letter of notes and other obligations, direct or contingent, owing by us to you at December 31, 1945, and the nature and amount of any collateral that you were holding on that date.

An addressed envelope is enclosed for your convenience in replying.

Very truly yours,

Austin Mfg. Company

by J. P. Stebbins

Date made	Date due	Nature of obligation	Amount	Rate of Interest	Interest paid to	Collateral

The above statement is correct.

Date________________ By________________________

payees, and amounts, or, perhaps, an adding-machine tape showing amounts only. This he should compare with the voucher or disbursement record to make sure of its accuracy. Procedures followed at the year end for the purpose of bringing into the accounts all expenses as well as purchases unpaid should be reviewed

and tested. A reclassification entry will then be necessary (for the working trial balance) in which accrued items and other obligations required to be separately stated on the balance sheet will be removed, leaving in the account "trade" accounts payable: creditors for merchandise, supplies, equipment, outside services, and expenses generally.

A debit balance among accounts payable usually means a return of merchandise to the supplier, an overpayment, a failure to record a purchase, a lost discount, or an error in posting. If, after adjustment or reclassification, the debit balances remaining amount to as much, say, as 1 per cent of the credit balances of accounts payable, they should be reclassified as "miscellaneous" receivables.

A confirmation of the amounts owing to individual creditors may be desirable where payments have not been made on the basis of individual invoices or groups of invoices, or where the cut-off procedure at the year end has been none too rigorous. Samples selected for the test should include smaller creditors as well as larger.

An indication on the list of accounts payable of items outstanding for more than the "clean-up" period of 30 or 60 days may bring to light unrecorded returns or disputes, which may lead to adjustments downward or further accruals.

If it should develop during the course of the audit that merchandise has been received on consignment, the records in connection therewith should be obtained and the status of each consigner ascertained. Where the handling of goods on consignment is the exception rather than the rule, the auditor must make sure that sales, less agreed commissions and expenses, have been set up as a liability and that no merchandise still held in the name of the consigner has been included in the inventory.

Dividends Payable

In his examination of the minutes of the board of directors, the auditor will have noted any dividend declared but not payable before the end of the year. Such a dividend is, of course, a current liability, which can be easily verified by multiplying the rate appearing in the declaration by the number of shares outstanding in the hands of the public. The auditor should remember that no dividend should be accrued on treasury stock or stock held in funds owned or controlled by the company. However, the prevailing practice is to accrue dividends on intercompany-held stocks as though they were held by outside interests.

Unclaimed dividends occasionally appear. Where they are minor in amount they may be included with dividends payable or with accounts payable; and they should continue to be carried as a

payable as long as the shares of stock to which they relate are outstanding.

Accrued Expenses

Accrued expenses differ from accounts payable in that (a) invoices, in the ordinary sense, are not on hand for them, (b) they are incurred more or less in proportion to elapsed time, and (c) the benefits from them accrue before they have to be paid. In one sense, they contrast with *prepaid* expenses where the benefits derived continue to flow after they have been paid for. Yet the classification is not a rigid one for such small items as rent, light, heat, gas, and water costs. Since they are settled for mostly on a monthly basis, they may be taken up at the end of each month, on an estimated or actual basis, as accounts payable, leaving, as the major items of accrued expenses, payrolls, commissions, traveling expenses, bonuses, taxes, interest, royalties, service guaranties, and similar items.

Federal income taxes. At the end of Chapter V, audit procedures 13, 14, and 15 relate to the review of the Federal income-tax liability for the current year. The information called for is suggestive only because the basic law changes to some extent each year and auditors must examine accruals of income taxes in the light of these changes. The instructions indicate some of the points the auditor should not overlook in the development of his working papers—points that will probably be considered in the computation of taxes for at least some years to come. Most public-accounting firms have tax departments or individuals to whom the tax problems of clients are referred. The specialization now necessary for an adequate review of the year's tax expense of a business organization having problems beyond those of the simplest type cannot be acquired by the average auditor within the time at his disposal.

Where, as a part of the audit engagement, the income-tax return is to be prepared, it is preferable to have the firm's tax specialist perform the work in the field while the annual audit is in progress.

Property and other taxes. State and local taxes are generally levied on persons who are owners of property on a specified date in each year. A property tax is the result obtained by multiplying the assessed value of the property—often a variable—against a rate established for the year. The auditor's function can be no more than to examine the bill for its authenticity, or to offer no objection to accruals based on last year's bill plus or minus known changes in assessments or rates. Assessed valuations usually have no relation to cost or depreciated cost and are often a fraction, established by law, regulation, or custom, of the assessor's estimation of "full" value. The preferable accounting for property

taxes is to accrue them (as an expense and current liability) during the twelve-month period immediately preceding the earliest payment date. Sometimes property taxes are regarded as prepaid since they often are used to pay governmental expenditures of the period following. To this, the auditor does not seriously object, since no accounting principle has been developed that prefers one method over any other, and the amount is not usually important from the point of view of its effect on the balance sheet (points already noted in connection with deferred charges).

Royalties. On machinery not owned, a royalty or a straight monthly rental may be paid. Or, royalties may accrue because of patents owned by another company or person, the business under audit being merely the licensee and paying an agreed amount per unit of production or sale. The quantity of production or sale to the date of the balance sheet should be ascertained through the operating records and an examination made to see if adequate credits have been accumulated.

Commissions. Salesmen for manufacturing concerns and wholesale houses are nearly always employed on some sort of commission basis, and the various arrangements that may exist should be ascertained by examination of employment contracts. Sometimes the commission remains unpaid until the customer has settled his account, in which case it is necessary for purposes of internal control to separate commissions deferred, and commissions earned and payable.

Salaries and Wages. Officers and executives are, as a rule, paid on a monthly basis, whereas the shop and office forces are paid weekly or semimonthly. The liability for each class is nearly always separately determined. From the shop payroll, for example, for the week containing the last day of the fiscal year, can be obtained usually satisfactory proof of the accrued liability by applying to the gross payroll a ratio equal to the number of hours pertaining to the fiscal year, divided by the total hours included in the payroll.

Deferred Credits

Deferred credits are unearned gross income; charges for goods or services that offset them have been realized in cash or may still exist in the form of a liquidating receivable, and the goods are yet to be delivered or the services rendered or the accounts collected. In the average enterprise they are limited to advance deposits or billings, rent, interest, unearned dues (of a club), and unearned subscriptions (of a magazine publisher). These items offer little accounting or other operating difficulty. If they are numerous,

like subscriptions, simple schemes are set up whereby their spread over future periods is automatically provided for.

Items of deferred income ultimately are normally classified as current liabilities, not because they are to be paid in cash as are other current liabilities, but because (1) they resemble valuation accounts, except that they cannot usually be identified with particular assets (the cash realized has become merged with other cash); and (2) at least a moral obligation remains that they be regarded as subject to refund or cancellation until delivery of the goods or services has been completed or the accounts have been collected. Their gradual release as gross income should, of course, accompany an equivalent flow of the goods or services, or the collection of related receivables.

Long-Term Indebtedness

"Funded," "bonded," and "long-term" debt, and "fixed liabilities" have very nearly the same meanings in commercial practice. They usually refer to the formal type of indebtedness represented by bonds or notes of either the coupon or registered type, originally sold through an investment banker to the public; they have standard face values, bear a fixed rate of interest, are readily transferable from one owner to another, and mature serially or at a single, specified date. A trustee, as mortgagee, may stand ready to act for security holders in case of default or other emergency.

External controls over security issues make the auditor's examination of long-term indebtedness a comparatively light task. When the issue is sold, or on the occasion of a first examination, the auditor makes a detailed study of the transaction—the trust deed or indenture, the marketing agreement, qualification details prepared for state security commissions or the Securities and Exchange Commission, the prospectus, opinions of counsel, minutes of stockholders and of the board of directors. He examines vouchers or other support for expenses attending the sale and reviews transactions since the original sale. He compares the recorded proceeds from the sale with the marketing agreement and examines the trustee's reports on bonds issued. He makes a list of the financial requirements imposed by the indenture, such as the method of paying interest and principal, the method of computing the trustee's annual fee, restrictions on the use of proceeds or profits, minimum working-capital ratio or amount, and periodic reports. Indentures do not make easy reading and the auditor may wish to review his interpretations of them with his client's counsel. From this initial study he prepares a point list for his permanent file that will serve as the basis for the annual review

thereafter. He also prepares an analysis of the original sales transaction for the permanent file with provisions thereon for future transactions. As a rule, no current papers need be prepared during succeeding audits—transactions may be summarized, with whatever comments may be necessary, on the permanent-file worksheet.

A bond-discount schedule is necessary for the permanent file and, where maturities are fixed and are likely to be met, the amortization expense may be computed several years in advance or for the entire period of the issue. The bond discount and expense is nearly always spread in proportion to the amount of interest scheduled to be paid each year (or, as explained in Chapter IX, in accordance with each year's outstanding principal, which is the same basis), and compliance of book entries with the schedule should be noted on the permanent-file worksheet each year. Prepayments of maturities call for an immediate amortization of the portion of the remaining deferred charge pertaining to the retirement.

Periodic deposits to a sinking-fund trustee may be required by the indenture. Confirmation should be procured from the trustee as to the make-up of the sinking fund at the balance-sheet date, including bonds repurchased. Occasionally, it will be found that the trustee is permitted to purchase bonds as a fund investment and hold them alive until their maturity. However, whenever a repurchase is made by the trustee, regardless of the reason for the repurchase or of the fact that the bond may be held alive in the fund, a corresponding entry should be reflected on the books of the corporation by means of which the bond repurchased is recorded at par, any premium or discount, adjusted by the portion of the unamortized discount on the company's books pertaining to the repurchased bond, being carried to current income or expense. This procedure permits the sinking-fund balance, which excludes the bonds held by the sinking-fund trustee, to be deducted, on the face of the balance sheet, from the bond obligation outstanding. Interest paid on bonds so held—the amount of which reduces the future liability—should not, of course, be charged to expense but as an additional payment to the trustee.

In addition to payments to the trustee, the indenture may require the creation of a sinking-fund reserve—in reality, a simple reservation of earned surplus. The auditor should see that the balance thereof conforms to indenture requirements, which may provide that it be maintained at a level equal to the payments made to the sinking-fund trustee, to the cash and bonds held in the sinking fund, or to some other figure. But, in any case, the prefer-

able classification of the reserve on the balance sheet is as a subdivision of earned surplus.

Unissued or reacquired bonds should be fully accounted for by examination as at each audit date or, where they are in the possession of others, by written confirmation. If they have been pledged, a balance-sheet disclosure must be provided for.

Interest accrued and paid during the audit period may be verified as long-term obligations are being reviewed. A simple interest check, excluding interest on unissued or "treasury" bonds, is usually deposited with a paying agent (who is often the trustee), and the obligor's liability therefor is then fully discharged; in this case it is not customary to regard the assets and liabilities of the paying agent, which relate to interest on the obligation, as those of the obligor. But where the paying agent functions in a true agency capacity, cash on hand at the balance-sheet date and a current liability of the same amount for coupons not cashed must be taken up in the financial statements of the obligor. In either case, the semiannual interest check must be in the paying agent's hands on the date specified in the indenture; otherwise, a default will probably have occurred. Paid coupons should be canceled by the paying agent through the use of a perforating stamp and returned to the obligor as evidence of payment; or they may ultimately be cremated, in which case a certificate of cremation should be secured for the obligor's files.

A confirmation request from the client, similar to that shown on page 154, should be addressed to the trustee:

Contingent Liabilities

Contingent liabilities differ from *real* liabilities, not with respect to the definiteness of their amount (either may be computed exactly or estimated), but in the definiteness of their incidence. A *real* liability must be paid by a specific person or organization whose identity is certain and whose obligation to pay has already been established; a *contingent* liability becomes a real liability only upon the occurrence of an event that creates an obligation and determines the obligor.

Certain contingencies represent possible losses, and others, losses that may possibly be recovered from others—that is, a contingent liability may or may not be matched by a contingent asset. Both types, however, require similar disclosure, since the chances of recovery on contingent assets is often remote.

Discounted receivables. Notes and acceptances discounted are probably the most common form of contingent liability. Provision is made in the bank-confirmation letter (Chapter VI, p. 74)

(Name and address of trustee)

Dear Sirs:

Please confirm to our auditors, Messrs. Hyatt, Paterson and Company, 960 Hudson Bldg., Chicago 3, Illinois, the following items, as at December 31, 194–, relating to our issue of First Mortgage Bonds for which you are acting as trustee:

1. Name of issue.
2. Date of indenture (or mortgage).
3. Principal certified and outstanding.
4. Principal amount reacquired by you:
   a. Held alive in sinking fund.
   b. Retired and canceled.
5. Date to which funds for the payment of interest have been deposited with you.
6. Amount of interest funds on deposit with you.
7. Make-up of sinking fund in your hands.
8. Other funds on deposit with you.
9. Collateral or other securities on deposit with you.
10. Direct or contingent liabilities on our part, not mentioned in your answers to the above, owing to you.

An addressed envelope is enclosed for your reply.

Very truly yours,

____

by__________________

for a listing by the bank of contingent obligations—these include not only discounted receivables but also accommodation endorsements or guaranties of which the bank has direct knowledge. The auditor's review of the notes-receivable register will usually reveal the items discounted. If the discounting has taken place with persons other than the client's regular depositories, confirmations as to any notes still outstanding should be secured by the auditor. For purposes of internal control it is good practice to maintain a notes-receivable-discounted account, which is relieved of its credit entries only when positive assurance has been received that makers of notes have paid them.

Endorsements and guarantees of performance. As an accommodation to customers, suppliers, and affiliated interests, business enterprises may be called upon to endorse commercial paper that is the primary obligation of others, or to guarantee performance under a contract to deliver a product or to perform services. The endorsement of specific notes involves a definite risk that requires disclosure on financial statements; guarantees of performance may, however, give rise to such remote risks or risks offset by recoveries of such value as to make their disclosure unnecessary. The auditor must judge each case on its merits.

Judgments, damages, suits. Examination of legal bills and inquiry as to the services attorneys have rendered often reveals the existence of litigation that involves a contingent obligation; a minimum-settlement estimate by the client's attorney may warrant the accrual of an actual liability. Confirmation as to estimated contingent and actual liabilities should be obtained directly from attorneys; an example appears in the Illustrative Audit. The average corporation lawyer is well acquainted with the auditor's requirements in this connection. Damage claims may be covered, wholly or partly, by insurance, and consideration should be given to this possibility when determining the amount of the contingency.

Additional income taxes. Additional income taxes may have to be paid covering years still open to audit by the Bureau of Internal Revenue. Revenue agents' reports may actually be on hand, indicating additional liability—reports that the controller or tax officer may believe can be overcome by argument or presentation of additional facts. The auditor's conclusions will be affected in part by the amounts of additional taxes paid in the past few years because of the same or similar points on which the latest reports are based. Whether additional or contingent liabilities should be recognized, in case the auditor finds his opinions in conflict with the client's representatives, is a matter the auditor should review with his principal.

Product guarantees. During his inquiries on sales activities (Chapter V, pp. 53-56), and as a result of his scanning of returns and allowances, the auditor will have determined whether an adequate provision has been made for returns and losses in the form of a valuation reserve that has been based on past experience or other probabilities; and he also will have determined what further contingencies exist because of guarantees attaching to new products, the risks on which, the future may show, have not been fully provided for; or attaching to individual sales of a class not usually guaranteed. The auditor must always distinguish between risks which past experience and present practical judgments can evaluate, and risks for which these determinants do not exist. The latter class may run into material amounts and thus require mention, even though the risk cannot be stated in dollars; on the other hand, it may be too small or imaginary to justify inclusion among disclosed contingencies.

Where the sales contract or recognized customer policy calls for the rendering of a replacement, repair, or adjustment service over a period of more than a year, the deferral of a portion of the selling price as unearned income may be called for, and the deferral plan should call for the periodic amortization of the unearned amount over a specific number of periods.

Contracts. In his talks with the sales group and other management representatives, the auditor should seek information as to the existence of any contracts under the operation of which losses or other uncompensated-for risks are likely to be encountered. Occasionally the auditor finds an alternative contingency: damages that would follow nonperformance of an unprofitable contract.

Purchase commitments. The existence of commitments for future purchases at a cost in excess of the present or a likely future market price may affect materially the financial position of a business, unless there are offsetting sales contracts or continuing sales prices against which the commitments have been made. The possible loss may be measured by the amount (usually less than the contract-market differential) for which the supplier is willing to settle if the commitment be canceled, or by the potential loss of gross profit. But since the actual purchase will bring about a loss only if prevailing sales prices decline (a possibility on which reasonable opinions can only rarely be secured), the prospect of loss is too uncertain to justify full recognition as an accrual on the books. In his list of contingent liabilities the auditor will probably value it at the price differential, with the understanding that the figure shown is in the nature of a maximum. Occasionally, situations are found where commitments greatly in excess of normal volume have been entered into, to cover orders or con-

tracts that have since been canceled or sales that are no longer made. If the quantities are too large to be stored by the client or ultimately absorbed in production, a possible loss may develop that should be included among the contingent obligations.

Another type of obligation needs to be disclosed on the balance sheet: commitments covering construction or new equipment—provided the dollar amount substantially exceeds normal yearly replacement requirements. Such items are not contingent liabilities in the ordinary sense, but they must be revealed because of their effect on financial position.

Infractions of law. Penalties may arise from violations of laws or regulations administered by governmental agencies. Occasionally, the liability will be substantial and the possibility that it has already reached the "actual" stage should be discussed with the person responsible for relationships with the agency.

Liability remaining from property sold. A vendor of real estate that has been sold may have a contingent liability with respect to a mortgage that he has passed along to the new owner, unless he has secured a release from the mortgagee or has received a bond from responsible third persons guaranteeing him against any future liability. Opinion of counsel should be obtained in such cases.

Internal Controls

Controls over expenditures generally, especially as they relate to operations, have been described in Chapter V. Other controls often advocated by accountants are:

1. Restriction on issue of notes. Frauds are occasionally found where an official will issue a note in the name of the company, possibly paying interest from his own pocket or even from the company's funds for some time thereafter. In such cases the payee must accept some measure of blame since he has not taken the trouble to ascertain whether or not he is dealing with the company or with an individual. A prospective note creditor should ask for, and expect to receive from the company's secretary, a sworn copy of minutes of the directors authorizing certain individuals to borrow money or issue notes in payment of goods or services. Without such assurance, the creditor has not acted with the prudence customary in business transactions, and in most jurisdictions he would be unable to hold the company liable. Every board of directors should, therefore, issue an authorization of the character indicated, even though no note issue is in prospect. It is usual, in such a resolution, to require the signature of two top officials, and to limit the character of the transactions for which notes may be given, or to specify by name or class the banks or persons to whom notes may be issued.

2. Note register. A note register should be required as an accounting record, in which the details of every note issued are formally entered.

3. Interest approvals. Interest vouchers should require the approval of both the treasurer and controller.

4. Expense authorizations. Routines should be firmly established whereby responsible officials undertake to approve commitments for the various classes of expenditures, within the limitations imposed by operating policies and the budget. In general, each expenditure should require two approvals at the commitment stage: the first from the person whose organizational unit demands the goods or service, his approval being an indication of (a) the *need*, (b) the conformity of the *use* to operating policies, and (c) the sufficiency of the *budget* allotted to his organizational unit; the second from the person (purchasing agent or, for services, some other official) who must choose or approve the *source* of the goods or service and arrange for and follow up on timely delivery or performance. Under a clearly defined policy of this type, it is not difficult for operators, even those who take pride in independence of action and in "getting things done," to subordinate their spending habits to a procedure that benefits the business as a whole.

5. Accruals. Procedures are needed in every business, regardless of its size, that will act both as an aid and a check on the setup of accrued expenses at the close of each month and at the year end. Such procedures may take the form of "precast" journal entries, or a single journal entry that includes a list of the needed adjustments and provides for their computation and approval as far in advance of the end of the period as possible. They will focus attention within the period to questions then requiring investigation and action that, if left until after the period has ended, may be difficult to answer and will interfere with other matters then demanding attention.

Balance-Sheet Standards

In displaying liabilities in a balance sheet, the following three points must be covered: the nature, security, and due date of each item. Convention supplies most of these. Thus, it is not customary to show the due date of a bank loan because it appears under "current liabilities" and current liabilities are accepted as being payable within a year; and, unless certain current payables are secured by pledged assets, no mention of security need be made, because current liabilities are usually not secured. However, the three points should accompany the setting forth of long-term liabilities, since the conditions under which they arise vary greatly; in addition, the interest rate should appear, in view of the fact that

interest paid to long-term investors is of importance to many persons.

Any portion of a long-term liability that becomes due within the next twelve months must appear under the heading of "current"; this includes payments that are to be made to a sinking-fund trustee.

Current liabilities should be divided, as a rule, into the following classes, where they exist:

Loans from:
 Banks (demand loans should appear separately)
 Others (the source class should be given)
Trade notes (acceptances should appear separately)
Notes to or advances from (specify which):
 Officers and employees
 Stockholders
Trade creditors
Federal income and profits taxes
Accrued interest
Dividend payable

In addition, individual liabilities should appear where they are likely to have importance to persons who customarily rely upon balance-sheet information. This requirement may be defined roughly as involving any item that exceeds 5 per cent of the total of current liabilities.

Both pledged assets and the liability secured should be identified on the face of the balance sheet, so that the effect of the possible future set-off may be apparent to the reader.

As noted in Chapter IX, unamortized bond discount is a proper, though uncommon deduction from bonds outstanding, along with "treasury" or reacquired bonds, and bonds held by a sinking-fund trustee.

Contingent liabilities may be shown "in short" between liabilities and net worth or in a balance-sheet footnote. The latter of these alternatives has some advantages in that the description may be less formal and more detailed than a sidehead. The existence of contingencies revealed by the presence of a surplus reserve, or a so-called "liability" reserve, does not need to be repeated under the contingent-liability caption.

Audit Procedures

1. Prepare or obtain schedule of notes payable, showing date of origin, renewal date, due date, payee, nature of original transaction, amount, payments, endorser, collateral given, rate of interest, and interest paid and accrued.

2. Confirm by correspondence all notes payable, and any assets held as collateral.

3. Compare record of notes canceled during year, as shown on the books, with canceled notes on hand.

4. Note changes in notes payable since year end and ascertain reasons therefor.

5. Obtain list of payables at year end; compare details with voucher register or payable ledgers, and total with controlling account; verify total of list.

6. Review effectiveness of cut-off controls, for items other than materials-and-parts purchases already covered in inventory examination.

7. Trace selected items from authorization through to payment, noting any returns, discounts, or other reductions and their possible effect on the amount outstanding at year end.

8. Examine items payable at year end that are also unpaid at time of audit and determine why payment has been delayed.

9. Examine file of open purchase orders and contracts dated prior to year end, and make note of any unusual items.

10. Scan voucher register subsequent to year end and invoices not vouchered at time of audit for items in transit or actually received during period under audit.

11. Test creditors' regular monthly statements against recorded liability at year end.

12. Request from selected creditors list of unpaid invoices at year end, where cut-off controls are weak and detailed statements are not at hand.

13. List separately amounts owing officers and employees, deposits and advance payments from customers, and deferred income, and other items requiring separate disclosure; determine whether any of these items is in effect a trust, requiring a corresponding segregation of cash.

14. Prepare schedule of accrued liabilities outstanding and how computed or verified.

15. Determine whether adequate accruals have been made for such items as the following:

Income and excess-profits tax
Sales tax
Franchise tax
Real-estate tax
Personal-property tax
Excise tax
Capital-stock tax
Social-security taxes
Payrolls
Pension-fund contributions
Bonuses
Salesmen's and others' commissions
Rentals
Interest on notes payable
Interest on funded debt
Dividends declared but unpaid

16. Make sure that property-tax accruals have been made for the taxing jurisdictions in which the company's property is located.

17. Refer to firm's tax department for determination of liability that should be reflected on balance sheet against any item of deferred income.

18. Look for and determine the significance of contingent liabilities relating to such items as accounts and notes discounted, claims for damages, guarantees of product or of performance by others, endorsements, patents, threatened or active litigation, compliance with orders of governmental agencies, purchase orders on a falling market or involving unusual quantities, or inability to deliver under contract.

19. Secure representation from client's independent legal counsel on any such items with which he is conversant.

20. Confirm amount of long-term debt outstanding by correspondence with trustee, mortgagee, or creditor; if indenture or other loan agreement has been modified, obtain certified copy of change.

21. Determine whether indenture provisions affecting current year have been complied with.

22. Examine reacquired bonds or cremation certificate evidencing their destruction, or secure from holder statement of their existence, and reason for their being so held; review bond transactions during year and bring permanent file on bonds up to date.

23. Verify interest paid during audit period and accrued at end of period, and verify changes in bond-discount or bond-premium account.

CHAPTER XII

Paid-In Capital; Surplus

"Capital," in textbooks and in general financial usage, has a number of meanings: amounts that have been contributed by investors in exchange for an enterprise equity (paid-in capital, a part or all of which, in the case of a corporation, may be "legal" capital); contributions of stockholders and accumulated earnings that remain in the business (net worth); and stockholders' contributions, stored-up earnings, and long-term borrowings (economic capital). Accountants as a rule do not use the word independently but use it in combination with other words. "Net worth" is the only brief term thus far devised to cover paid-in capital and accumulated earnings, but its general employment has been hampered by fears that it might signify too much, since the balance-sheet amount to which the term applies may have little relation to the "value" of the enterprise as reflected in stock prices or capitalized earning power. These fears are not shared by the author. Objection to many other accounting terms and words could be made on the ground that someone may adopt their original meanings and thus be misled. The derived meaning of "net worth" is clear and has been uniformly applied wherever it has been used. "Capital surplus" is another term frequently under fire; but over a long period of time, the term has covered items arising from so many different sources that its use could profitably be discontinued; "paid-in surplus" and "revaluation surplus"—often the chief elements of capital surplus—are in good current use in the financial world and are far more informative to readers of accountants' reports. "Earned surplus" has also come in for its share of criticism, but it has stood the test of time, its coverage is undisputed, and substitute terms such as "undistributed earnings," "retained profits," or "reinvested net income" add neither clarity to the concept nor brevity to the name.

Principles

The basic elements of net worth are paid-in capital (capital stock or legal capital plus paid-in surplus) and earned surplus. Occasionally, a third element, revaluation surplus, may be found under the heading of net worth; but since values other than cost or

depreciated cost find little support among accountants, revaluation surplus and its asset counterpart are best omitted from financial statements; or the revaluation credit, adequately earmarked, may be deducted along with depreciation reserves from related assets. The measure of paid-in capital is the amount of cash or fair value of property paid in for stock; original transactions and subsequent changes in paid-in capital should be approved by all classes of stockholders.

An issue of capital stock (a) for services, (b) under an option given to officers, or (c) as a dividend, together with the value to be recorded, should bear the prior approval of stockholders. The value to be put on the books should be the market value of the stock at the time of issue, or, if there be no readily determinable market value or, if market value be less, the average paid-in value of the stock of that class previously issued. Where the amount paid in upon the exercise of an option given to officers is less than such value, the difference should be charged to current expense as compensation for services. Amounts paid in as the result of the exercise of options or stock rights given to all the stockholders of a certain class are customarily credited to paid-in capital without adjustment, although in some instances the right may have aspects of a stock dividend.

No expense, loss, or net operating loss should be charged against paid-in surplus unless earned surplus has first been exhausted; and then only after the charge has been specifically approved by the stockholders.

The cost of stock reacquired (whether it be held in the treasury or retired) should be charged against the capital-stock account of the same class up to the average par or stated value per share in that account; any excess of cost should be charged against the paid-in surplus account pertaining to that class of stock, up to the average amount per share in that account; and any remaining excess of cost should be charged against earned surplus as an effective distribution thereof. An alternative but less desirable practice is to carry treasury stock at cost and on the balance sheet deduct such cost from the sum of the capital-stock and surplus accounts; and, when sold at a profit, to credit the profit to paid-in surplus; or, when sold at a loss, to charge the loss on each share to paid-in surplus in an amount not in excess of the average paid-in surplus per share, any loss not thus absorbed being charged to earned surplus.

Internal Controls

Stock exchanges require a registrar or transfer agent or both for listed securities. The function of the transfer agent is to main-

tain the stockholders' ledger and approve titles to original issues and subsequent transfers, and that of the registrar is to make sure there is no overissue of the security. For nonlisted securities where there is neither registrar nor transfer agent, the controller should keep the stockholders' ledger (or make periodic inspections of it if it is kept by the corporate secretary or treasurer), and stock certificates should be issuable only when signed personally by two officers of the company.

Balance-Sheet Standards

1. For each class of capital stock it should be possible to determine from data appearing on the balance sheet the authorized issue, shares issued, treasury shares, shares outstanding, the average amount paid in per share, and the total amount paid in.

2. Paid-in surplus, if relating to more than one class of stock, should be shown separately for each such class.

3. For each class of preferred capital stock there should appear, in addition, wherever these features exist, the amount to which the stockholders are entitled in the event of involuntary liquidation (and the best policy is to value the stock on that basis, adding to the amount paid in, where necessary, a transfer, authorized by stockholders, from earned surplus), the price at which the stock may be called (if noncallable, that fact should be stated), preferences as to dividends including participation in added distributions, dividends in arrears, the nature of option or conversion rights outstanding including rate, price, amounts and periods effective, and sinking-fund requirements.

4. Stock subscriptions should be deducted from "stock subscribed" under net worth and only the amount actually paid in should be extended.

5. Alternatives have been described above for the treatment of treasury stock. In no event should treasury stock be shown as an asset.

Audit Procedure

1. Procure from the transfer agent a certificate showing the number of shares outstanding.

2. If there be no transfer agent, run a tape of the stock ledger, or where there are less than one hundred stockholders, compare the stock-ledger balances with the list of stockholders maintained in the permanent file, and bring the list down to date. Compare changes recorded in the general ledger with the stock-certificate book; make sure that certificates representing stock repurchased and retired have been canceled and that the stubs of new certifi-

cates are accounted for and are properly filled in. Examine or test the propriety of the value of Federal documentary stamps attached in the case of stock transfers and new certificates issued.

3. Review, with responsible official, treasury-stock transactions during the period and analyze these transactions.

4. In a first audit, or, in the audit next following the sale of a new issue, the surrounding circumstances should be carefully studied. Documents to be reviewed will be charter provisions, bylaws, and state laws relating to the class of stock sold, agreements with bankers and underwriters, statements, reports, and the prospectus filed with the SEC and with state authorities, the object being to determine whether all the requirements have been met and the conditions under which assets were acquired. The consideration received should be traced into the cashbook, or, if property was paid in, the inventory and disposition of the property should be reviewed; the method of valuation, if not cost or depreciated cost, should preferably bear the approval of stockholders.

5. Review preferred-stock agreements and ascertain whether the requirements under these agreements have been fulfilled.

6. Where there has been a reduction of "legal" capital, make sure that the necessary corporate action has been taken and that the state authorities have been notified as required by law.

Earned Surplus

Earned surplus is the accumulated excess of net income over dividends paid. Only the net operating results for each year and the dividend charges should be found in the earned-surplus account. Other earned-surplus charges and credits are sometimes made but the auditor should convince his client, if he can, that a "clean" surplus account will stand him in better stead than any attempt to make the income statement reflect "earning power." No income statement can possibly reflect future earning power with any degree of precision and attempts to make it do so (which usually lie behind surplus charges and credits) are likely to prove more misleading and distorting to readers than making the income statement a mere reflection of the items determined to be income and expense within the period covered by the statement. Financial statements offer enough difficulty to accountants in their preparation and they yield the maximum of information to outsiders when they are regarded simply as historical summaries.[1]

[1] For a further discussion of these points by the author see *Contemporary Accounting* (New York; American Institute of Accountants, 1945), Chapter IV, pp. 2-5.

Surplus Charges and Credits on Published Statements

Among the typical surplus charges and credits that accountants are often prevailed upon to omit from the income statement are the following:

1. Prior-year expenses not discovered during previous periods.
2. Adjustments of income-tax expense for prior years.
3. Reduction of prior-years' profits by reason of profit renegotiation agreements.
4. Adjustments of prior years' operations by the adoption, during the current year, of pension plans that date from a point in an earlier year.
5. Premium or discount on the retirement of long-term obligations.
6. The cost of the investment in a subsidiary company or in a company that has just been merged, in excess of the book value on the other's records at the time of acquisition.
7. Goodwill no longer recognized as having value.
8. Provisions for liability and operating reserves.
9. Depreciation-reserve increases or decreases following agreements with the Bureau of Internal Revenue.
10. Gains and losses on sales of fixed assets.
11. Write-down of foreign investments.
12. Actual or prospective losses on domestic investments.

By omitting such items from the income statements year after year (and more often than not they are material in amount)—a practice, condoned by accountants, of many corporations—the net profit shown by the successive income statements becomes almost meaningless, and, what is much worse, the door is opened for manipulative practices on the part of less scrupulous business managements. Such devices may be employed to make the current year's net income correspond closely to last year's, to raise current net income in order to justify bonuses to officers, to lower future depreciation charges, and for various other purposes. Accountants who acquiesce in these practices fail to realize that they are casting a needless reflection upon the integrity of the financial statements to which they certify—since under these circumstances the surplus account can always be assumed as not having been closed—and that a more rigorous no-surplus-adjustment policy on their part would add much to the meaning of financial statements to investors.

Balance-Sheet Standards

1. Earned-surplus changes during the audit period may be shown on the face of the balance sheet. These will normally be

limited to net income and dividends and, with capital stock, may appear as follows:

CAPITAL STOCK & SURPLUS:

Common capital stock: 1,000 shares, $50 par value, authorized, issued, and outstanding			$50,000.00
Paid-in surplus, arising from original contributions of stockholders			11,245.00
Total paid in			$61,245.00
Earned surplus:			
Balance January 1, 1946		$14,963.12	
Net profit for year	$27,488.38		
Less—dividends of $10 per share	10,000.00	17,488.38	32,451.50
Total December 31, 1946			$93,696.50

Objections are sometimes raised to this procedure because the analysis of surplus is the only historical summary on the face of the statement and is therefore an exception to the treatment accorded other balance-sheet items. That is, the balance sheet is ordinarily conceived to be a statement of "balances"; why, therefore, should analyses of other items not appear? But the surplus analysis clearly indicates the relationship between the two principal statements in an accountant's report or in a corporate report to stockholders, and it does away with the need for a third statement, thereby simplifying the presentation of financial information. And, on the mechanical side, there is almost always sufficient space on the liability half of the balance sheet for the analysis, assets ordinarily requiring more space than liabilities. However, if the analysis involves more than a few items, a separate earned-surplus exhibit should be prepared.

2. The elimination of an accumulated deficit (i.e., negative earned surplus) by offsetting it against paid-in surplus or other form of paid-in capital (a "quasi-reorganization") should always be authorized by the stockholders. In subsequent financial statements (a period of three years is suggested by the SEC), earned surplus should be "dated" from the effective date of the offset (by adding to the earned-surplus sidehead "from" followed by the effective date).

3. A change in the name, state of incorporation, or characteristics of its capital stock will usually have no effect on the continuity of the earned surplus of a corporation. But the establishment of a wholly new company or the formation of a single

company by combining two or more companies results in the elimination of existing earned-surplus accounts, on the theory that a new corporation cannot start operations with distributable surplus (i.e., the old surplus, added to the paid-in-capital accounts, has been contributed for new stock issued and has thus become a part of paid-in capital).

4. Restrictions on the use of earned surplus for dividends should be disclosed on the face of the balance sheet (in the sidehead or in a footnote). Possible restrictions include such items as the following:

a. Any voluntary or contractual appropriation of earned surplus reduces the free earned surplus and the amounts so appropriated should not be regarded as available for dividends until they have been returned to earned surplus through formal action by the proper authority (which is usually the creating authority). Examples may be found in a reserve for contingencies (a voluntary reservation authorized by the board of directors), and in reserves, required by bond indentures, of earned surplus of a specified amount or of an amount accumulated at a specific date.

b. A bond indenture may also provide that no dividend be paid that has the effect of reducing working capital below a given ratio or below a specified money amount.

c. A restriction is usually held to exist in the amount by which preferred stockholders' rights in involuntary liquidation exceed the paid-in capital already assigned to that stock. Agreements with preferred stockholders may also call for the annual reservation of a specified quantity of earned surplus (in a sinking-fund reserve) in order to insure the retirement of the preferred stock by a certain date.

d. Preferred-stock dividends in arrears are sometimes regarded as a contingent liability; but, in view of the necessity that dividends be formally declared by the board of directors before *any* liability for dividends can be said to exist, the more common practice is to insert after the sidehead of earned surplus some such qualification as "restricted in the amount of preferred-stock dividends in arrears of $2 per share, or, in total, $40,000."

5. Except as noted in No. 2, above, no losses or expenses should be charged to any form of surplus or surplus reserve; they should be carried through the current expense accounts of the year they are incurred, or if they are substantial in amount, and are prior-year or clearly extraordinary or nonrecurring items, they should appear in a final section of the income statement for that year.

Audit Procedures

1. A "clean" earned surplus requires only the examination of dividends. No earned-surplus details need appear in the current

working papers. Summarize transactions for the year in the analysis maintained in the permanent file.

2. Refer earned-surplus charges and credits, if any, to principal for decision. Develop details of each item.

3. Abstracts of minutes of the board of directors will indicate the dates and other details pertaining to each dividend declared during the period. Compare with the actual transactions.

4. Review each dividend in the light of the restrictions attaching to the act of payment, to working capital, and to the use of earned surplus.

5. Obtain opinion of counsel as to the propriety of any dividend, cash or stock, charged to paid-in surplus, depletion or depreciation reserves, or revaluation surplus.

6. Test details of dividend payments by comparison with certified lists of stockholders or with stock ledger.

Reserves

The word "reserve" has been used loosely by accountants and as a consequence present-day practices in connection with reserves are very much muddled. Some accountants have advocated narrowing the coverage of the word to appropriated earned surplus, but the profession has not yet adopted that standard. Readers of balance sheets must continue to recognize and distinguish between the varied uses of the word.

Balance-Sheet Standards

1. Four classes of reserves are recognized:

a. Liability reserves, which are accruals of expenses incurred, computed by best available estimates—for example, reserve for Federal income taxes. They are classified as current or long-term liabilities, according to their nature.

b. Operating reserves or valuation accounts, created by charges to expense and representing expirations of costs already incurred. Examples of these are reserves for depreciation, amortization, bad debts. On the balance sheet they are shown as reductions of the assets to which they are related.

c. Appropriated surplus or surplus reserves, created by transfers from earned surplus, and remaining intact except for further transfers of the same kind or returns to earned surplus—for example, sinking-fund reserve; reserves for contingencies, working capital, retirement of preferred stock. They should be classified on the balance sheet as subdivisions of earned surplus.

d. Mixed reserves, which are any combination of the above. Examples are discussed in No. 2 and No. 3 below. Where the purpose or effect is or is likely to be a smoothing out of operating

results as between years, a mixed reserve is called an "equalization" reserve. Mixed reserves appear on published balance sheets between liabilities and net worth.

2. Reserves created by charges appearing in the income statement should represent liabilities or valuation accounts and be so classified on the balance sheet. However, in recent years, it has been common practice to follow the same procedure in establishing or adding to reserves for contingencies, postwar adjustments, and similar remote, indeterminate, possibly never-to-be-incurred liabilities. At the same time, no standards have been fixed whereby the propriety of future charges against such reserves may be determined. These reserves are equalization reserves, which most accountants, at least on paper, have long condemned. The effect is to transfer a portion of the profits of prosperous years to subsequent periods when profits will be tempered by competition. The same general financial purpose could have been carried out, with much less misunderstanding to investors, by appropriations of earned surplus, or more simply still, by building up earned surplus.

3. An insurance reserve in a commercial enterprise is a current liability if created by a charge to expense representing actual or estimated costs of replacement or damages payable covering events that have already occurred. But an insurance reserve created by charges to expense, which are the equivalents of premiums otherwise payable to an outside insurer, is an equalization reserve the balance of which, under more orthodox accounting methods, would be divided between reasonably determinable accrued obligations and an earned-surplus subdivision or unappropriated earned surplus. In practice, however, insurance reserves are classified with other heterogeneous reserves between liabilities and net worth.

4. Retirement and similar reserves, created by charges each year to income that represent actuarial or other reasonable estimates of the current period's contribution to future payments, should be classified as long-term obligations except for the portion thereof to be paid during the next following year, which should appear as a current liability.

5. Summaries clearly explaining the charges and credits in appropriated-surplus and mixed reserves should accompany published financial statements.

Audit Procedure

1. Analyze each reserve account for the audit period, and add a synopsis of the analysis, or the analysis itself, to the permanent file.

2. Make sure that every charge against an appropriated-surplus or mixed reserve closely conforms to the purposes of the reserve

and that it is not an ordinary or recurring expense commonly charged to operations.

3. Note whether additions and deductions are of the same nature as in previous years; discuss unsettled points (from previous years) with principal and review analyses with him.

4. Accounting policies and general business policies are inextricably intermingled in setting up and operating appropriated-surplus and mixed reserves. It is always important, therefore, that proposed policies (governing both the creation and subsequent use of the reserve) be clearly formulated when each reserve is established and that the board of directors give its approval to such policies.

5. The auditor should always counsel against the creation of mixed reserves because of the resulting confusion and uncertainty in the interpretation of the income statement, both during the years in which the reserves are built up and in the years during which expenses and losses are being charged off to the reserves. The auditor, well within the limits of professional propriety, might even recommend against the establishing of any appropriated-surplus or mixed reserve unless required by contract or by regulatory authority.

Revaluation Surplus

In published financial statements, the term "revaluation surplus" or "unrealized appreciation" has virtually disappeared. In many instances what was left of appreciation was reversed in the 1930's, and any remaining appreciation has been eliminated through gradual realization or by having been merged with paid-in surplus where it remains concealed under the heading of "capital surplus." Revisions of fixed-asset accounts, many of which have been occasioned by the conclusion of the war—and the abandonment of plants or their modification for peacetime operations—have been reflected in cost write-downs or eliminations and in adjustments of depreciation and amortization reserves both up and down. But, from the lessons learned following World War I, it seems improbable that upward revisions of fixed-asset valuations will be undertaken on the scale which developed in the 1920's. A few accountants still remain who cling to the notion that business management or appraisal engineers should be the unrestricted determinants of asset valuation and that accountants should accept their findings. In cost, however, over the years, it has been demonstrated that a more objective basis is available that is less subject to management caprice and more understandable to conservative management and to investors and others who seek to be guided by financial statements.

Balance-Sheet Standards

Revaluation surplus should be (a) eliminated where practicable, inserting, should the amount be significant, a valuation notation in the asset sidehead, or (b) deducted, undiminished, on the face of the balance sheet, like a valuation reserve, from its related asset, or (c) where the accounting procedure is of long standing, carried between paid-in and earned surplus. If (c) is followed, depreciation on the full value should be included in depreciation expense.

Audit Procedure

1. A full explanation and analysis of the revaluation excess should appear in the permanent file. This will include a summary of the appraisal report from which the item originated, the initial adjustment placed on the books and the authority therefor, and any subsequent adjustments.

2. "Realized appreciation" is often recognized in an annual transfer from revaluation surplus to depreciation expense (or to earned surplus where the revaluation credit appears under net worth). The amount of this transfer is ordinarily the result of applying a percentage (equal to the current provision for depreciation—based on the original appraisal figure—divided by the original appraisal figure) to the original revaluation excess. The method followed should succeed in amortizing the revaluation excess over the life of the assets included in the appraisal.

Proprietorship and Partnership Accounts

In noncorporate enterprise the net-worth accounts are almost invariably represented by proprietors' or partners' accounts, to which the net profit for the year and withdrawals are carried. The accounts should be analyzed for the full audit period and the auditor should question any item that has the appearance of belonging to the business rather than the individual. Because the boundaries of noncorporate enterprise are much less distinct, there is some chance that the expenses of the business include personal items, and, on the other hand, it may be that transactions that should have been recorded on the books were handled by the individual proprietors. This is more likely to occur in smaller enterprises where many of the internal controls, such as they are, are in the hands of the proprietors themselves. The auditor should, therefore, be on the alert for these possibilities; if strong business controls, rigidly enforced, are wanting, he may find it necessary to qualify his report.

Audit Procedure

1. Analyze each proprietorship account or partner's account, bearing in mind the possibilities above mentioned.

2. Discuss each analysis with the proprietor or partner concerned and secure from him a written representation that (a) indicates the correctness of the balances of his capital account and any other account relating to him, his family, or his interests, and (b) states that all transactions affecting the business, of which he has knowledge, have been properly recorded on the books during the audit period.

CHAPTER XIII

The Detailed Audit

A detailed audit is an extension of an ordinary annual audit, required in those cases where internal controls are found to be weak or where, for any reason, procedures are to be thoroughly examined. Its purpose is to review original transactions for their authenticity, clerical accuracy, and completeness, with such attention to classification as the occasion demands. A detailed audit may also be required when a defalcation has occurred or irregularities have been noted, in order to determine the extent of the loss or error and the procedural corrections necessary to prevent a recurrence. Many auditors include in their annual examinations a detailed audit of certain types of transactions for limited periods of time, for such varied reasons as these: (a) the practical operations of internal controls may thus be more fully tested; (b) by no other means is it possible to ascertain whether prescribed operating procedures are being followed or the usual standards of business are being lived up to; (c) it is important to have the client's employees recognize that outsiders, at least annually, are going to get far into the details of individual transactions, thereby providing an added incentive for high standards of performance in their daily work; (d) the client has requested at least some examination of details more intensified than testing or sampling. Once it has been established as a recurring feature of an annual audit, the detailed examination is usually limited to one or two months' transactions; it may cover, primarily, purchases, sales, payrolls, and general-journal entries, with some added examination of cash transactions beyond that accompanying the usual audit procedure.

In contrast with the audit methods described in preceding chapters, where the emphasis is on the testing of accounts and the internal controls under which they are built up, the procedures followed in a detailed audit have as their major objective the determination of whether individual transactions have been correctly recorded and carried through the accounts. The detailed audit is the "acid test" for policies, principles, and practices that the business is supposed to be observing. In the testing process, which

constitutes the work done in the greater portion of the annual audit, the auditor's labors vary inversely as the excellence of the internal controls; in a detailed audit, the auditor's procedures, once the operating sector of the business and the months to be covered have been decided upon, is more likely to vary, as between engagements, mostly in accordance with the worth of the original records—a situation conditioned to a great extent by the initiative and competence that the auditor finds at operating levels.

A detailed audit originating from special causes may be performed at any time; a detailed audit that supplements an annual audit is almost always performed during the audit year, less often after the period has closed.

The audit program appearing in the Illustrative Audit includes a section on detailed audit. This section may be regarded as a typical coverage accompanying a recurrent audit engagement. The month or other period or periods selected (September, in the illustration) should be varied each year; if November or December is included, a portion of the "busy period" will probably have to be devoted to detailed-audit work—a type of employment better suited to other portions of the year. Yet this period of coverage will occasionally be necessary if the primary purpose of the detailed audit is to stimulate good work by employees throughout the year.

An audit program covering work of a detailed nature should be supplemented by an understanding between the auditor and his principal on such points as the following: (1) details of the procedure to be followed, with emphasis on points needing investigation disclosed in last year's audit or in conversations with the client during the year, (2) the nature of working papers to be prepared in support of work done, (3) types of problems to be discussed, without the assistance of the principal, directly with the controller or other official, (4) types of problems to be referred to the principal for review with the client's representatives, and (5) nature of written or oral report, if any, to client on the findings.

An audit of a joint venture, syndicate, or trust, although nominally a "balance-sheet" examination, may prove to be virtually a detailed audit, since, in such cases, it is so often necessary to verify each transaction during the period covered.

Examining Vouchers

The word "voucher," as used by accountants, is usually limited in application to expenses and journal entries; the typical voucher consists of a folder or top summary memorandum and various attachments.

From the auditor's point of view, the ideal voucher supporting a

cash disbursement is one that, with its attachments, at the time of its preparation or years later, completely and convincingly justifies the expenditure to any third person such as himself. The auditor must always lend his unqualified moral support to a "tough" voucher-audit activity within the business—an activity not limited merely to making sure that authorizing documents bear specified signatures, but an activity that extends to frequent reviews of the methods being followed at the encumbrance, purchasing, receiving, inspection, adjustment, and approval levels. Whether the whole activity is carried on by the voucher-audit head or is divided among several individuals—the internal auditor, the controller, and a representative of the general management—is immaterial, provided only that the end product is an unvarying stream of good vouchers.

Following are the points on which the auditor must satisfy himself in examining a voucher:

a. *That the obligation has not been paid before.* If the approval or payment date has not been perforated through the voucher and its attachments, a comparison of various dates will indicate whether the sequence of events supports this conclusion. Any seeming irregularity should be explained by the voucher-audit clerk. If the existing system permits papers to be removed, the auditor should affix a rubber-stamp impression or distinctive checkmark on each voucher and supporting document, so that it may not be presented to him a second time without detection.

b. *That the obligation was authorized.* A requisition or other formal request for the purchase should be among the attachments, bearing the signature of the person who has been authorized to incur the particular type of expenditure involved; if it does not, the files of the purchasing division must be consulted. A list of authorizing signatures should be at hand for comparison.

c. *That the goods or services were ordered.* The purchase should have been made in accordance with existing policies as to the number of bids solicited, or as to other general or special limiting conditions that have been imposed on the purchasing division by higher authority. The order should have been subjected to other routines within the purchasing division that would insure the most favorable deal available in the way of quantity, quality, date of delivery, discounts, both trade and cash, conditions of rejection, and payment. If the auditor finds orders being placed regularly with certain suppliers, without periodic tests of prices and delivery service, his report should so state. Many purchasing short-cuts are found in practice. Blanket orders or price orders for a year's requirements or for unspecified requirements of raw materials and other items are of frequent occurrence; for the mutual protection

of both the business as a whole and its purchasing division, these should always be placed under policies approved by the general management. If no such policies exist, a recommendation may be made that long-term purchase orders be individually reviewed and approved by some member of the top staff superior to the head of the purchasing division—or even by the board, where the auditor has observed that higher prices are being paid or competition among suppliers has not been secured.

d. *That the goods or services were supplied.* Evidence should be attached showing receipt, inspection, and acceptance or rejection, in the form of either a single receiving report or separate receiving and inspection reports, and, where material or merchandise is involved, an acknowledgment that the items received and inspected have been accepted by the storekeeper. Quantities approved should, as a rule, be the result of an actual count by both the receiving division and the storekeeper. Receipt of services is usually indicated directly on a copy of the creditor's work order or invoice or in a separate memorandum from an official authorized to approve the service. The auditor should see that deductions have been made for any shortages or rejections, or for other adjustments noted on the receiving and inspection reports.

e. *That prices paid were market prices.* Tests to indicate the propriety of prices paid are usually possible for a large portion of the purchases of materials and supplies. Purchasing agents, as a rule, have some form of record (sometimes a copy of the purchase order, filed by name of material or supply) in which quoted prices for particular items are recorded, along with names of suppliers and other details, for future reference. Prices appearing on invoices should be compared with this record and with market quotations obtained from independent sources; these sources will be trade journals or financial newspapers for the more common raw materials. Correspondence with suppliers other than the client's is sometimes resorted to.

f. *That quantities, prices, and amounts are clerically accurate.* Quantities and prices on the voucher summary and the several supporting documents should be compared. The auditor should make certain that the number of units received is multiplied against the agreed price for the same type of unit, that extensions and footings are correct, and that deductions for returns, allowances, and discounts have been made.

g. *That payment has been made.* Use of the voucher number as the check number, insertion of the check number on the voucher, or the presence of some other cross-referencing device, will enable the auditor to trace the obligation represented by the voucher through to its payment (or to accounts payable). As a rule, com-

parison of a group of vouchers with canceled checks will take place as a separate operation, and the checks may, at the same time, be subjected to other tests. An alternative is to compare the voucher with the entry therefor in the voucher record, compare the voucher-record entry with its corresponding entry in the check register, and, finally, compare the check-register entry with the check itself.

h. *That the expenditure has been correctly accounted for.* Accounts to be charged with the expenditure will appear in the voucher-summary form. It is not enough to be satisfied with the internal controls surrounding the original "coding" operation; the auditor must be satisfied that the accounts to be charged are the ones he would have charged had the determination been his, and he must examine the accounts indicated, to make certain that they, and not others, were the ones debited in the posting operation.

As this brief summary has indicated, it is always best, when making a detailed audit of expenditures, to commence whenever possible at the beginning—that is, the point where the need for the expenditure originates—and to carry individual transactions through to their payment and posting. Only in this way can the significance of operating procedures and the protective devices surrounding the disbursement of funds be fully understood.

Purchase Adjustments

Separate accounts are customarily provided for purchase returns, purchase discounts, and other debits affecting amounts otherwise payable to creditors. Aside from scanning these accounts and tracing down the larger amounts, the auditor's main problem will be to ascertain whether all adjustments have been made that should have been made. He must study the sources of the recorded adjustments, scan the records at these points, and discuss the methods followed and the possibility of open items with those responsible for initiating adjustments.

Examining Payrolls

If a detailed audit of one month's payrolls is to be made, and during the month two payrolls, say, have been prepared, much time can usually be saved if they are examined together. As with every disbursement, the auditor must commence with the authorization for employment and trace through the intervening steps to the canceled payroll check.

So many variations enter into payroll procedures of different organizations that all that can be essayed here will be an outline of the leading points to be covered in *any* payroll examination, together with their application to a single assumed situation—a

manufacturing enterprise having, say, 500 factory and 100 office employees, both paid twice monthly, with a separate payroll for each group. The illustration should also prove helpful in indicating the type of information the securing of which is a condition precedent to an intelligent detailed examination of other items.

a. *Employment authorization.* In the practical situation mentioned, payroll forms are prepared in advance for each payroll, one day following the close of the payroll period and two days before payment. Each employee's name, department, rate of pay (hourly rate for factory employees and semimonthly rate for office employees), and the date on which the present rate of pay was made effective, appear on an addressograph plate, kept in a locked file in the personnel-records office under the supervision of the assistant personnel officer. He is present whenever the payroll forms (an original and two carbon copies) are made up from these plates. Neither the payroll clerk nor any other factory employee has access to this file. When a new employee appears for the first time on a payroll, the assistant personnel officer initials the item and inserts the effective date and hour; a similar procedure is followed when a name appears on the payroll for the last time. Plates for former employees are kept in a separate file, and the last day of employment is written in on the back of the plate and the assistant personnel officer initials it. Since, in this case, the plates are filed alphabetically and are printed in the order of their appearance, the auditor's task is simply to see that the plates and impressions therefrom correspond, and that no new names have been inserted.

b. *Hours worked or work performed.* Continuing this illustration, factory employees punch a clock in and out daily, and one card serves for each two-week period. In addition, a time ticket is prepared daily by each employee and approved by his foreman, showing the job on which he worked, the classification of the work performed, and the hours devoted to each job and class of work. Both the clock cards and time tickets are kept by the payroll clerk; having obtained total hours by the aid of a comptometer, he inserts the total (showing overtime hours separately) on the payroll. The auditor, working from the payroll, checks back to the time tickets, mentally footing the total hours shown by the tickets; this he can do in even hours, without the necessity of an elaborate refooting of the tickets. Subsequently he compares the clock-card totals with the payroll totals. Hours worked by office employees are based on and are compared with the daily record maintained by an attendance clerk.

Where labor is paid on a piece-work basis, the auditor must seek in the underlying wage agreement the method of determining quantities and rates and compare totals indicated by the payroll

with operating reports. Most incentive plans, providing for bonuses, will require a detailed review of production records supporting the differentials on which the stated quantities of work performed are based.

c. *Rate of pay.* Continuing this illustration, the rates of pay printed from the addressograph plate have originated with the personnel division and the auditor's work order will have included the comparison of rates appearing on the payroll with those shown on the addressograph plates, to make sure no alterations or misreadings have taken place.

d. *Gross pay.* Audit of gross pay is simply the product of quantity times rate, or, in the case of office employees in the illustration cited, the gross pay is the rate that has been printed by the plate.

e. *Deductions.* The principal deductions, in the assumed illustration, are for savings bonds, social-security tax, withholding tax, and advances. A miscellaneous column is also provided on the payroll form for other deductions. When the payroll (in triplicate) is typed by the payroll clerk, an earnings record (a separate sheet for each employee) receives the first impression, and deductions are the same as on the previous payroll, or deduction changes are noted at the top of each earnings-record sheet in spaces provided for them. Where the employee is given the detail that results in the amount shown on his check (and this should always be given him), it is usually sufficient to examine the deductions in total rather than by individual employees. In the illustration, the second carbon copy of the payroll has horizontal perforations that make possible the giving of the detail of his portion of the payroll to each employee.

Deductions that involve payments to the Federal Treasury should be traced in total to controlling accounts, the balance of which are liabilities subject to separate review.

f. *Net pay.* The amount shown on the payroll to have been paid by check to the individual employee should be compared with the corresponding entry in the check register. Maintenance of a separate payroll cash account simplifies materially the review of both details and totals. Cash payments obviously cannot be verified except in total. Where payment is in cash, the best procedure on the part of the auditor will be to make a surprise visit to the payroll office during the period covered by the audit, thus examining payroll items as the payroll is being made up. He observes the methods of computing payroll details and keeping them under control, examines authorizations for changes in rates and deductions, watches the "envelope stuffing," and accompanies the paymaster (or his equivalent) as he identifies the employee and gives him his envelope.

g. *Distribution.* In an organization employing 500 wage earners, the auditor would expect to find the payroll totals carried to controlling or clearing accounts, details of gross pay having already been spread, on a daily, weekly, or monthly basis, to departmental, job-cost, construction, or other expenditure accounts. He would ascertain the basis for the spread and prove its accuracy and that of the resultant posting.

Petty Cash

Reviewing petty-cash transactions involves the same basic procedure as that required for the examination of vouchers. The principal difference is in the nature of the transactions and in the lack of cross relationships when funds are disbursed. The transactions are those that are customarily paid in cash and for which crude receipts rather than formal invoices are received in exchange. Carfare, postage, express charges, repairs of office equipment, emergency supplies and services—these and similar small outlays make up the bulk of petty-cash vouchers. The auditor should be familiar with the review given such vouchers when reimbursements of the fund are made; he will often find the reviewing responsibility assigned to a person who has no other disbursement-control function and who regards the job as a purely perfunctory one. Despite the inevitable informality of the expenditures, the auditor can, as a rule, very quickly reach a conclusion as to the propriety of petty-cash disbursements—by inquiring into repeating items, establishing the identity of persons to whom funds are frequently given, looking for similarity in the signatures of presumably different individuals, and ascertaining reasons for gradual or sudden increases, should they appear. Where he finds weaknesses, he should do his part in insisting, for the future, at least, that supporting tickets, cash-register slips, and other original evidence be rigorously sought for and preserved.

Expense Reports

A frequently neglected area of expenditure may be found in travel and other individual-expense vouchers. While the auditor can, as a rule, do little more than make sure that items of past travel and other personal expense do not violate existing regulations that the company or any of its divisions have promulgated in an endeavor to set top limits, he can frequently regard his detailed audit of these vouchers as furnishing ample cause for advocating needed improvements in expense-allowance standards. Among desirable standards for most organizations are stated per-diem allowances for room and meals, graduated, where necessary, as between employee groups or types of locations, tabulation of charac-

teristic business expenses for which reimbursement may be claimed and personal expenses which the traveler must himself bear, nature of permissible Pullman accommodations, limitations on entertainment expense, and other items, peculiar to the business, on which adjustments have been difficult in the past. Without a reasonably strict code for such expenses, they may easily get out of sensible bounds and be the cause of much embarrassment between top executives whose judgments as to the need for frugality or openhandedness may differ widely.

Journal Entries

The bulk of journal entries, including year-end adjustments, will already have been examined in connection with balance-sheet and operating items. Month-end adjusting entries need to be scanned only, for the purpose of discovering (a) changes in amortization or accrual procedures that might influence judgments of comparative monthly operating results, and (b) changes in accounting method. Transfer entries may be passed if they are corrections of classification or postings; or, if they represent reclassifications, their importance on comparative analysis should be weighed and noted. Other entries, not answering these descriptions, will be few in number; the auditor should investigate them in detail to whatever extent may be necessary in order to assure himself of their propriety and trace them into the accounts. It is always good practice for the controller to approve each general-journal entry, at least the nonroutine variety; if his approval does not appear, the auditor should discuss the more important entries with him.

Sales

On pages 53-56 of Chapter V there appears a series of points that form a basis for the auditor's general inquiries concerning sales. The answers to the questions raised should be borne in mind by the auditor when framing a plan for his detailed examination of this item.

Some test should be made of the completeness of records of (a) sales orders, (b) the filling and recording of the orders, and (c) their ultimate conversion into cash or their cancellation or adjustment. Although much will depend upon the character of the records and on the thoroughness of internal controls, including internal audit, the most satisfactory procedure will probably be to trace successive transactions from the earliest record of the sales order to the final collection from the customer—a procedure resembling, in reverse, the detailed examination of purchases. Where the detailed audit is to be limited to a month's transactions, and

the location of the bookkeeping records permits, it is best to select the orders received during a given month and follow them through to their liquidation in cash, although billing and collection may occur in later months; by this procedure the auditor can more easily observe the continuity of detail (e.g., nature of items ordered, shipping instructions, terms, delivery date, invoicing, and settlement). If he cannot thus follow through on each transaction, he should, for the reason cited, perform the consecutive steps as quickly as possible. Where original orders are numbered, he should obtain satisfactory explanations for missing numbers; if an order has been altered, the authority therefor should be sought. In some instances, item quantities can be built up from sales orders that may be reconciled, without too much difficulty, with finished-inventory quantity controls. Occasionally, commissions paid salesmen can be translated into sales dollars. Or, where cash sales are involved, cash-register tapes may be available for the building up of a dollar sales figure. Whatever the procedure adopted, the attempt should be made to set up a total "order" figure that can be accounted for in subsequent steps, thus avoiding questions of completeness for such steps. If the total cannot be evolved, or, if obtainable, cannot by any practicable device be traced through to the sales account on the one hand, and cash or adjustments on the other, the auditor will have to depend upon the examination and tracing of individual orders.

Cut-off procedures at the year end are generally regarded as an object of inquiry belonging to a balance-sheet audit (see Chapter VIII, p. 102), and are thus not a matter to be considered in a detailed audit.

Because of the possibility of loss through poorly controlled noncash credits to customers, it is usual to find a careful routine through which they must go before they can be recorded. Hence, the task of the auditor in examining each such item is (a) to determine whether the routine was accurately observed, and, in at least partial proof thereof, (b) to scan correspondence with, or advice from, the customer, indicating that the credit has been claimed.

Cash Transactions

Although the main *sources* of cash receipts and the main *objects* of cash disbursements may be given adequate examination, it is still necessary, in detailed-audit procedure, to give consideration to the cash items not covered in such examination and to such matters concerning the handling of cash as have not been recognized elsewhere.

The auditor will find, in the average case, that the categories of cash receipts and disbursements remaining over from the exami-

nation described in previous chapters and in the first part of this chapter, will be, for any one month, few in number. The items of which these categories are composed should be reviewed at length: their sources, correspondence or other data, originating from without, attesting their nature and amount and their disposition. When expenses or other items, which normally make their initial appearance in other records, are cleared through the cash-book in the first instance, the auditor's examination, in addition to that prescribed elsewhere, would include an inquiry into the occasion for by-passing regular procedures.

Remaining requirements for the detailed audit of cash transactions will usually be satisfactorily covered if all of the audit procedures, including the "additional" procedures, suggested at the end of Chapter VI, are carried out.

Footings and Postings

The extent to which footings and postings are verified is a problem common to all the items already considered in this chapter. Generally, in a detailed audit, books of original and final entry should be footed and the correctness of postings to controlling and other accounts should be proved. But the auditor should not perform these operations blindly; in fact, he should avoid them whereever possible, which means wherever they would constitute useless duplication. And even if they are necessary, he should adopt such short-cuts as are practicable, his object being to save time and avoid getting mired in clerical detail.

Time is often saved by making an analysis of ledger postings. A worksheet is prepared with account names in the first vertical column; successive columns are given headings for posting sources, and a recapitulation of the postings in each account for the period of the detailed audit is spread through these columns. When the analysis has been completed and the columns have been footed, differences between these footings and those appearing in the books of original entry for the same period should lead readily to the detection of such errors as the following: (a) incorrect footings of journals or ledger accounts, (b) the posting of incorrect amounts, (c) errors corrected in one record but not in the other, (d) unjournalized postings, and (e) offsetting errors. Postings to wrong accounts will not always be detected by this process, except in obvious cases; but it is usually satisfactory, where a cursory inspection of the accounts does not give assurance of correct postings, to make mental subtotals (e.g., in thousands only) of the different classes of items in each book of original entry and compare them with the subtotals appearing in the ledger-analysis columns.

Mental footings (again, in thousands or more) are usually ade-

quate substitutes for the formal footing of books of original entry or ledger accounts, provided clerically accurate footings have, presumably, already been made by members of the client's staff.

Where individual postings are being traced from one record to another, distinctive check-marks should be placed after (or before) the individual items in both records; when the tracing has been completed, a search for original posting references in the second record, not accompanied by check-marks after them, should reveal any items that have not actually originated from the first record, although they have been so tagged.

The reader must again be reminded that an adding-machine tape not prepared by the auditor or his assistant should never be accepted as proving the correctness of a total. A new tape, prepared by the auditor, is always required.

CHAPTER XIV

Closing the Audit; Financial Statements

Having concluded his formal program, the auditor has reached a point where it is necessary to review what he has done, dispose of any matters remaining open, prepare (or, if already prepared by the client's staff, edit) the financial statements, discuss them with the management and procure management's representation thereon, and draft a report. During any or all of these operations, which should be carried on in the client's offices wherever possible, the auditor will be working closely with his principal, and the principal will be going over the auditor's working papers and procedures generally. The sequence of events, however, will depend on the nature of the engagement, the availability of the principal, and other factors.

Completing the Working Papers

Before the auditor turns to the preparation or review of the financial statements, he should see to it that his working papers and the permanent file have been fully completed, and, in particular, that the following things have been done:

1. *Working papers are in good form.* Papers relating to each section of the audit should be assembled, put in some logical sequence, and indexed, with summaries, on the top sheet, of figures, with adjustments. A review of each sheet should be made in order to make certain that the details are legible and understandable to others, and that no open points remain. Each detail sheet should tie in with the summary or some preceding sheet, and cross-references should appear on both (see paragraph 9, p. 15, Chapter II); likewise any relationship worth noting of items anywhere in the section with items in other sections should be indicated. Totals, unadjusted and adjusted, appearing on the top sheet should be cross-referenced to the working trial balance. The purpose of this seemingly elaborate tie-in is twofold: others are aided when they review the papers, and the auditor's principal is assured, subject, doubtless, to the principal's own testing of the auditor's dependability in this respect, that every figure fits into the working trial balance. The scheme of cross-referencing followed in the Illustrative Audit may be studied in this connection. Separation should

be made of papers belonging to the client; an item on the auditor's agenda should be provided for their return.

2. *Narratives of work done are informative and accurate.* The nature and content of narratives (see paragraph 7, page 14, Chapter II) should be restudied; in view of the fact that they were prepared as each section of the audit was completed, perhaps several days or weeks previously, the auditor, at the conclusion of the engagement, has the opportunity of looking at them with a fair degree of objectivity and can revise them in the interest of greater clarity, or add to them information gleaned subsequently from other sources. The auditor must always strive to improve his narratives so that they may be as terse, realistic, informative, and factual as possible.

3. *Adjustments and reclassifications have been reviewed and approved.* Adjustments and reclassifications of ledger accounts that the auditor proposes to make should be reviewed by him (and usually his principal) before they are presented to the client. Each adjustment must be warranted—either because it is material in amount or because of the existence of practices of which the adjustment serves as a formal reminder. In addition, the auditor must be certain of the accounts, and of the amounts to be charged or credited to each account. The precise procedure for securing their adoption by the client is likely to be different for each engagement, and it will normally be determined by the auditor's principal before the audit begins. In some cases the principal will review them and discuss them with the client; in others, the task will be left to the auditor, at least for certain types of adjustments, or the adjustments may be passed on informally to the client's accounting officer as they occur.

During the past few years the assertion has often been made that the financial statements to which the public accountant subscribes are not his, but his client's. He persuades but has no way of compelling his client to adopt preferred accounting procedures and to accept adjustments and reclassifications when they are necessary. In most cases the professional accountant virtually dictates the form and content of financial statements; yet, if his audit be considered as a whole, this action is no more than a polishing-off process—a job not unlike that of the editor who stands between the author and his public. The transactions that underlie every financial statement are the client's, but the method by which summarized transactions in the form of financial statements are presented to outsiders is by custom left to the public accountant. If, however, the client refuses to give expression to adjustments considered by the public accountant as necessary to a fair showing of the results of his audit, the accountant must qualify his findings as set forth in his report or certificate.

Explanations accompanying journal entries should be sufficiently detailed so that the client's staff will be directed to their sources. If the auditor wishes, in addition, to refer in the explanation to his own papers, that portion of the explanation should be bracketed so that it will not be reproduced when the adjustments are given to a typist for copying.

4. *Adjustments have been given effect on the books of account.* It is not enough to secure agreement on the adjustments originating with the auditor; he must see that before his departure the books have been conformed to the figures that will be reproduced in his report. He should, therefore, compare ledger balances, after adjustment, with the final column on his working trial balance, or, where the books have not been held open, he should trace the adjustments into the accounts.

5. *Financial statements have been approved.* Mention has already been made of the desirability of securing the client's approval of the form, content, and footnoting of the financial statements that the auditor proposes to put in his report—the approval may take the form of the controller's signature on the final draft of the statements. It is customarily done at the same time the adjustments are reviewed, or it may be done at a later date. The auditor and his principal may also discuss the report draft with the client, although the public accountant always regards his report or certificate, and every word of its content, as his own responsibility. The report or certificate is now and must continue to remain his own affair, and this fact is universally recognized in business circles and by such governmental bodies as the Securities and Exchange Commission.

6. *The books have been scanned since the year end.* A protective device essential to any audit which is to be followed by a report or certificate is that the books be scanned by the auditor between the end of the audit period and the date of his report. For example, if the auditor completes his field work on March 20, covering the preceding calendar year, he will by custom put that date on his report. Because the report must be typed and referenced in the auditor's own office, a week or two may elapse before the finished document is put into the client's hands; and for what transpires in the business after March 20, the auditor cannot be held accountable. There is a tendency at present, however, to hold him accountable, along very broad lines, for noting any obvious major events that have been recorded on the books of his client during the interval between December 31 and March 20: transactions which relate to items appearing in the auditor's report or certificate and accompanying the financial statements, and which might conceivably have an important influence on the opinions of readers of

the financial statements as to the financial position at December 31 or the operating results for the period then ended. Following are examples of post-audit-period events that have recently been cited by public accountants in their reports:

Discontinuance of important product lines
Sale of plant
Purchase of plant
Settlement of important price dispute with government agency
Results of profit renegotiation
Settlement of income-tax liability for prior years
Suit for patent infringement against company
Judgment awarded to company against licensee
Refinancing or retirement of securities
Stock split-up
Stock dividend

In general, the events of which the auditor is expected to take formal notice are always relatively large, important in the life of the company, and notable in their effect on financial position or internal balance of assets or liabilities, or on past or future earning power.

The scanning process, in this instance, has as its sole object the search for unusual changes in both real and nominal accounts. If, in the example just cited, the auditor devotes March 20 to the task, he may examine the controller's monthly statements for January and February; compare them with previous monthly statements, including those for the corresponding months of the audit year; review the worksheets supporting the statements, making sure that they have been prepared from the books and that any month-end adjustments follow the usual pattern of adjustments; review the books of original entry for the 20 days of March, and discuss with the controller the possibility of any important unrecorded transactions. Where monthly statements have not been prepared, the auditor must scan the general-ledger accounts, or, if they have not been posted, the books of original entry.

7. *The permanent file has been brought up to date.* During his examination, the auditor has probably added material to the permanent file, especially in the case of funded debt, capital stock, surplus, and similar continuing items, where no current working papers have been prepared. He should now make the necessary additions to fixed-asset and other schedules and summaries, and prepare for the permanent file any new schedules or notes that he believes would be helpful in future audits or reviews.

Financial Statements

Within the past decade, financial statements have been fairly well standardized, and the same set of statements, with minor

variations, now serves most purposes. At the same time, the forms are sufficiently flexible to accommodate unusual situations. This does not mean that the stage reached is ideal, or even that the present development is not actually transitional. There will be further modifications, but these are likely to originate from outside influences, as did a number of changes effected in the years 1934 and 1935, following the publication of standard forms by the Securities and Exchange Commission. These modifications will undoubtedly be general and will apply simultaneously to the great majority of financial statements; the auditor should follow them as they are proposed and discussed in the professional journals. But with respect to the engagements for which he is reponsible, he will probably be instructed by his principal to observe the previous year's forms, with such alterations or additions as the principal may specify.

The general attributes that the public expects to find in every financial statement are truthfulness, clarity, conciseness, and consistency—truthfulness, so that the same basic information may be available to outsiders as is available to insiders; clarity, so that a common, wider understanding may be had; conciseness, so that points that lead to conclusions may stand out; and consistency, so that statements of one period may be compared with those of other periods and organizations. These are more than idealized virtues; they are the commonplace, working objectives of every public accountant when he passes on the form and content of the financial statements to which he is about to attach his name. Although they demand of him his best skills and an ever mounting degree of social responsibility, they are like other human virtues in that they often fail of attainment. They are not absolutes, but qualities of whose dimensions even the most conscientious can never be quite certain; and they are inclined to vary with time and place. Opinion and judgment are the tools through the use of which these objectives are applied to practical situations. What is right in a particular instance is often a matter of opinion; whether a disclosure should or should not be made may well be conceded to be a matter of judgment.

In the Federal Security Act of 1933 and in the regulations of the Securities and Exchange Commission, truthfulness is frequently referred to in oblique terms. Thus, in statements filed with the Commission, there must be "no omission to state a material fact . . . necessary to make the statements . . . not misleading," a material fact being defined as any matter on which "an average prudent investor ought reasonably to be informed." By this emphasis, attention is drawn to the fact that an accountant may be held responsible for not discovering and disclosing vital informa-

tion—a species of untruthfulness that may arise, not of necessity from any moral obloquy on the part of the accountant, but more often from failure to recognize on what an investor's decision to buy or sell is based. It is thus important for the accountant to realize that the four virtues that he is expected to pursue are not only imposed on him from without but are defined by outside authority.

A number of writers on accounting subjects have spoken in recent years about the "growing importance of the income statement." To the author, this emphasis is an idle one. The income statement and the balance sheet are interrelated statements; one cannot be produced without the other. They are both necessary to almost any financial analysis. What these writers may mean is that they would like to see the income statement develop as fully as has the balance sheet on such matters as disclosure and detail. But, as noted elsewhere in this book, the income statement can never advance to the point where it symbolizes earning power; it must, by its own terms, be confined to revenues and expenses, gains and losses, for a period already ended. Attempts to make of the income statement any more than a historical summary appear at this time to be doomed to failure.

Special-purpose balance sheets and income statements are probably best regarded as the all-purpose variety plus whatever additional information is required. Thus, statements filed with the Securities and Exchange Commission may contain more detail than the professional accountant deems necessary for the annual statements destined for stockholders; but they should contain no *less* information, the all-purpose models being generally regarded as containing the desirable *minimum* information for any reader. *Pro forma* statements may also be looked upon as all-purpose variants—that is, regular statements plus additional, superimposed transactions, the reasons for and the details and effects of which should be made an integral part of the statements. Reconstructed income statements of past years, from which "nonrecurring" or "extraordinary" items have been omitted, although frequently prepared and certified to by public accountants, are usually indefensible from attack on the basis that, while they omit the results of transactions that probably will not be repeated in future years, they provide no substitute: that is, if management will not duplicate past errors in kind, losses arising from new sources will doubtless be incurred for which no provision appears. But the accountant does not wish to stretch his imagination any further; therefore, his reconstructed income statements can be justly criticized as incomplete. It is much safer for both accountant and investor to rely on a segregation of income and expense by the years

during which they were recognized as such, with such hindsight emphasis on particular items as may be regarded in the future as deserving attention.

Experiments are made from time to time on the form of financial statements; current liabilities may be deducted from current assets, new sideheads are invented, or an objective classification may be developed for expenses. Usually, these experiments are concerned with exposition only and not content; a striking example of this came out some years ago when the "descriptive" balance sheet gained limited popularity. The answer to most of these experiments is that attempts to popularize complex items may actually give misleading results through oversimplification. The reader of the balance sheet must have some financial background; financial statements are not yet ready for consumption by the novice. Hence, a more rewarding effort could be devoted to the devising of ways and means of giving out *more* information that would seek to supply the reader with additional useful data.

Sideheads

Sideheads play an important part in giving intelligibility to financial statements. In reviewing the samples of balance-sheet sideheads that follow, the reader should distinguish between those (or portions of them) that convey information indicating that a standard of practice has been followed, and those that indicate an exception to more common practices. These illustrations have been excerpted from reports of industrial corporations to their stockholders for 1944 and 1945.

Cash

1. "Cash in banks and on hand"
2. "Cash in banks and offices"
3. "Cash on hand and demand deposits" [most accountants, however, avoid putting a less important item first]

Receivables

4. "Accounts receivable (less $75,000 reserve in 1944 and $70,000 in 1943)" [applied to comparative balance sheet]
5. "Trade accounts receivable:
   "United States and Canadian Government agencies and departments
   "Other
   [Total]
   "Less, allowance for doubtful accounts, cash discounts, etc."
6. "Accounts and notes receivable, less reserves:
   "Customers

"Affiliated companies
"Other
"Inventories, less reserves
[Total]
"Less: Progress collections on contracts
"Price adjustments accrued" [Amounts of these two items shown in italics]

Inventories

7. "Finished products, work in process, and raw materials and supplies (priced generally at the lower of cost or market)"
8. "Finished products, work in process, raw materials and supplies (based on physical inventories at September 30, 1944, adjusted to December 31, 1944) at cost which was not in excess of replacement market"
9. "Merchandise inventories—at cost (principally last-in, first-out) which did not exceed market (including amount of $296,959.46 in transit)"
10. "Inventories of materials, supplies, and finished product (valued at average cost or market, whichever was lower)"
11. "Inventories, at or below cost"

Investments

12. "U. S. Government securities"
13. "U. S. Government securities (other than tax-savings notes), at cost, which approximates market value"
14. "U. S. Treasury tax notes—at cost plus accrued interest"
15. "Investments in associated companies (not controlled)—at cost or less, and at less than values considered realizable"

Fixed Assets

16. "Land, buildings and machinery—at cost, less items fully depreciated and written off"
17. "Land, buildings, machinery, and equipment—at cost
"Less: Depreciation and amortization thereof allocated to operations to date"
18. "Property, plant, and equipment (including balance of unamortized appreciation of $3,551,101.50)"
19. "Nonoperating land, less reserve"
20. "Fixed assets, at cost:
"Land
"Buildings, machinery, and equipment, etc.
"Less: Reserve for depreciation
"Emergency facilities, less amortization $790,197.42
[Total]

"Plant property held for sale, not used in operations, less reserve"

Deferred Charges

21. "Deferred charges
    "Perishable tools
    "Inventory of supplies
    "Prepaid expenses"
22. "Deferred charges: prepaid insurance premiums, etc."
23. "Prepaid insurance and deferred charges"
24. "Prepaid insurance, taxes, and other expenses, and miscellaneous office supplies"
25. "Inventories of supplies, unexpired insurance premiums, prepaid taxes, etc."

Current Liabilities

26. "Accounts payable and sundry obligations"
27. "Accrued taxes (estimated)
    "Less: U. S. Treasury Notes Series "C", reserved for the payment of taxes"
28. "Accrued liabilities (including local, state, capital stock, and social security taxes)"
29. "Accrued Federal taxes on income for year"
30. "Notes payable—due on equipment ($9,152.00 secured by vendors' liens)"
31. "Advances from United States Government and other customers, less $26,465,471.63 applied as a reduction of receivables on terminated contracts, contra"
32. "Reserves for cost adjustments, wholesale discount, product warranty, etc."
33. "Current invoices, payrolls, etc."
34. "Accounts payable and payrolls"
35. "Sinking fund payment due on October 31, 1945, for retirement of fifteen-year 3½ per cent debentures"
36. "Employees' payroll deductions for war bond purchases, withholding and social security taxes"

Long-term Obligations

37. "Ten-year 2% debentures, due February 1, 1951"
38. "Funded debt:
    "First Mortgage 4% Bonds . . .
    "Bank loan:
      "Principal sum
      "Installments due during 1945, included in current liabilities
      "Balance maturing after December 31, 1945"

39. "Funded debt (less principal amount redeemable within one year):
    "Long-term bank loans, 1½%-2¼%
    "Ten-year convertible 3½% debentures, due March 1, 1949
    "Seven-year 3¼% debentures, due March 1, 1949"

Capital Stock

40. "Preferred stock—authorized, 2,000,000 shares of $20.00 par value each; issued 1,550,000 shares"
41. "7% Cumulative Preferred, $100.00 par, redeemable at $110.00 per share—
    "Authorized—22,200 shares
    "Issued—17,676 shares"
42. "First preferred stock, 8% cumulative, par value $100 per share, entitled in liquidation to $110 per share:
    "Authorized 96,930 shares; issued 94,925 shares"
43. "Common stock—Authorized 6,000,000 shares, no par value.
    "Issued, 4,409,185 shares, less in treasury 163,480 shares"
44. "Common stock without par value—stated value $6.25 per share:
    "Authorized 3,500,000 shares; 2,543,052 shares issued; 8,016 shares subscribed under employee stock plan; 9,366 and 6,216 shares allotted to employees at $29.25 and $26.25 per share, respectively; and 41,309 shares reserved for employees under employee stock trust agreements
    "Stated capital (2,551,068 shares)"

Surplus

45. "Surplus:
    "Capital (contributed by stockholders)
    "Earned"
46. "Earned surplus—since December 31, 1933"
47. "Surplus:
    "Paid-in and other capital surplus
    "Earned surplus"
48. "Surplus (minority capital stock holdings in subsidiary company represent an interest herein of $25,477.06):
    "Capital
    "From operations"
49. "Capital surplus arising from the purchase of preferred stock at less than par value"
50. "Surplus (earned, paid-in, and arising from revaluation of assets)"

The attention of the reader is called to the sideheads appearing in the reproduction of the typed copy of the report included in the

Illustrative Audit. These may be regarded as reflecting the standard of practice in the use of sideheads followed by the average public accountant.

Footnotes Accompanying Financial Statements

Footnotes are often employed by accountants in explaining more fully various items of financial statements, thus serving as sidehead extensions, and also in furnishing additional information that has no accepted place within a statement. The illustrations appearing below should give to the prospective auditor some idea of the type of material commonly going into footnotes and acquaint him with the sort of language in which they are phrased.

Among the more important items repeatedly found in published financial-statement footnotes at the time this is written (1946) are the following:

Methods of consolidation
Details of receivables from Government
Basis of inventory valuation
Disclosures of methods of depreciation and amortization accrual
Status of Federal income taxes
Earned-surplus limitations
Charges and credits to reserves for contingencies
Nature of contingent liabilities
Financial events following balance-sheet date

The following excerpts, from 1944 and 1945 annual reports to stockholders, should be regarded as typical of what may be found in current practice; but they do not always illustrate the best in accounting practice:

Methods of consolidating accounts.

1. "Net current and fixed and other noncurrent assets of the Canadian subsidiary amounted to $1,360,359.01 and $639,902.98, respectively. The official rate of 90.09 cents per Canadian dollar at December 31, 1944, was applied in translating assets and liabilities except that average exchange rates in the years of acquisition were applied to fixed assets. The consolidated net income for the period includes $137,951.35, representing the net income of the Canadian subsidiary translated into U. S. currency at the official rate of 90.09 cents per Canadian dollar."

2. "Following the precedent established in prior years, the Company's proportion of the net profit of a subsidiary, less than a majority of the voting stock of which is owned by the Company, has not been included in income for the year ended January 31, 1945, nor added to the Company's investment therein, but divi-

dends of $64,445 received from this subsidiary, in accordance with past practice, have been included in consolidated income."

3. "The net income of this wholly owned subsidiary for the year ended December 31, 1944, as shown in its financial statements amounted to $113,254.70. Translation into dollars has been made at the official rate of $4.025 per pound sterling, except that depreciation has been translated at exchange rates prevailing at time of acquisition of related fixed assets. A dividend of $80,500 was received from the English subsidiary in December, 1944, and is included with miscellaneous income in the statement of income."

4. "In the year 1944, approximately 17% of the gross sales of the Company were made to The American Rolling Mill Company. The Company is informed that The American Rolling Mill Company owned 554,774 shares, or approximately 60%, of the outstanding common stock of the Company at December 31, 1944."

5. "The Corporation intends to collect from subsidiaries eligible for consolidation for federal income tax purposes the amount of federal taxes on income (less postwar refund of excess profits tax) for which the subsidiaries would have been liable had they filed on a separate return basis, and the Corporation intends to pay the tax liability determined to be due on a consolidated basis."

6. "Earned Surplus includes undistributed surplus of foreign subsidiaries as follows: 1944—$39,512,320.30; 1943—$37,982,-252.84."

Inventory valuation.

7. "Cost of inventories is determined on first-in first-out basis. The aggregate of inventories at cost and purchase commitments open at the respective year ends was lower than the aggregate replacement cost thereof at those dates. No intercompany profits are included in the inventories."

8. "As heretofore, a fixed quantity of tinplate is carried at a constant price which is substantially lower than the present market price; the remainder of the inventory is valued at the lower of cost or market, generally on a first-in, first-out basis."

9. "Inventories of raw materials and goods in process are stated at the lower of cost or replacement market and finished products are stated at the lower of cost or realizable market. Cost represents average cost with the exception of molasses, which is valued on the last-in-first-out basis."

10. "The basis of inventory cost in general is (a) 'average cost' for materials and supplies and (b) 'first-in-first-out' for work in process and finished product."

Employee pension and retirement plans.

11. "Actuarial computation indicates an apparent deficiency of approximately $16,000,000 in amount reserved for pensions. The company's liability under the Pension Plan at December 31, 1944, representing pensions already granted, is computed to be approximately $13,229,000."

12. "In January, 1944, the Corporation adopted a retirement plan for the benefit of employees involving an annual cost of approximately $90,000. During the year ended July 31, 1944, there has been charged to profit and loss the amount paid in January, 1944 ($87,829) and an accrual of one-half of the estimated amount due in January, 1945 ($47,710). In order to establish the plan, a reserve of $528,101 has been provided from earned surplus to cover the past service benefits of the initial group under the plan. Of this amount, one-tenth ($52,810) was paid during the year and has been charged to the reserve. This amount, however, is allowable as a deduction from income subject to federal taxes, and, accordingly, the provision for federal taxes is reduced thereby by approximately $45,000."

Federal taxes.

13. "In calculating the provisions for Federal income taxes for 1943, the Company took into consideration the excess profits carry-over credits from prior years. The savings in such taxes resulting therefrom amounted to approximately $428,000. No such carry-over credits were available for the year 1944."

14. "Tax refund sought in claims filed or to be filed for the year 1944 and prior years under Section 722 of the Internal Revenue Code is substantial in amount. These claims have not been reflected in the company's financial statements."

15. "The tax returns filed by the company for the year 1942 have been examined by the government and the agent performing such examination has indicated that he intends to disallow certain of the deductions taken for that year, resulting in a substantial additional tax. The company disagrees with the position taken by the government and will contest any assortment which may be levied. As a matter of conservatism, the company has deemed it advisable to show as a current liability the reserve for contingencies previously established out of profits to cover possible liability, if any, which they may be called upon to meet in this connection."

Contingent liabilities.

16. "Customers' installment contracts having balances aggregating $41,244.59 have been sold under agreements to repurchase

in case of makers' default. All of these are secured by direct liens on trucks or busses. The payment of $64,800.00 principal amount of customers' notes has been guaranteed both as to principal and interest. Adequate reserves have been provided for all probable losses."

17. "A suit was filed against the Corporation in January, 1943, claiming infringement of certain patents in the manufacture of steel, and demanding an injunction and an accounting for profits and damages. The validity of such claim is not admitted and the amount, if any, payable pursuant to litigation thereof is not presently determinable."

18. "There were sundry lawsuits and claims pending at December 31, 1944, of a nature ordinary and routine in the oil-producing industry, in respect to which no special provision for possible liability is considered necessary."

19. "There has been pending before the National War Labor Board a number of union demands for increased pay and other benefits. Estimated provision has been made in the 1943 and 1944 accounts for possible retroactive effect of increased pay."

Additional information relating to capital stock.

20. "2¾% convertible notes of Paramount Pictures Inc. due December 28, 1951: On January 1, 1945, one-quarter of the principal of these notes became convertible into common stock of the Company. If Mr. Balaban continues in the Company's employ, the remaining three-quarters of said principal will successively become so convertible on the first of January 1946, 1947, and 1948. The conversion price, which is subject to adjustment under certain circumstances, is $25 per share. These conversion rights will terminate on December 28, 1951."

21. "All class A common stock and all preferred stock have been called for redemption and the funds necessary to effect the redemption have been deposited with the Redemption Agent and hence excluded from the balance sheet."

22. "The aggregate liquidating preference, including accrued dividends, of the 7% Cumulative Preferred stock at December 31, 1944, exceeded the par value thereof by $9,550,000; and the aggregate liquidating preference (after the Preferred stock) of the Class A stock exceeded its stated value by $15,947,828. These amounts exceeded the stated value of the Common stock plus the surplus. Counsel of the Corporation has furnished an opinion that, based on the assumption that no liquidation, dissolution, or winding up of the Corporation is contemplated, there is no restriction upon the

surplus of the Corporation with respect to payment of dividends by reason of these differences."

23. "In involuntary liquidation, the aggregate preference of the First Preferred, Preference and Class A stocks at December 31, 1944 ($20,229,250.57, consisting of $11,196,900.00 for the capital stock plus $9,032,350.57 for the cumulative dividends in arrears, as shown above) exceeded the total par or stated value of all capital stocks and surplus per books ($12,901,059.91) by $7,328,190.-66."

Surplus restrictions.

24. "Earned surplus is restricted as to the payment of cash dividends on common stock by an order of the Securities and Exchange Commission issued in connection with the sale of the company's sinking fund debentures and also by terms of the Trust Indenture securing the company's First Mortgage Bonds. Such restrictions, which are separate and not in addition to each other, amounted to $4,515,274.31 and $2,495,669.84, respectively, at December 31, 1944. (The company's earned surplus on the above date was $4,873,000.)"

25. "The amount of earned surplus available under provision of Supplemental Indenture to First Mortgage for payment of common dividends is $34,617,962.88 (out of a total of $52,189,000)."

26. "Under date of June 1, 1944, the Company entered into a Credit Agreement under which it is entitled to borrow up to $30,000,000 and which provides among other things that it will at all times maintain consolidated net current assets of $17,000,000 or more and that it will pay or declare no dividends (other than in its own stock) which together with dividends paid or declared after December 31, 1943, will exceed 75 per cent of its consolidated net earnings subsequent to December 31, 1943. The payment or declaration of a dividend shall not be considered a violation of this agreement by reason of a reduction in consolidated net earnings thereafter resulting from losses or renegotiation of contract prices. (Under this agreement consolidated net earnings are defined as net profit of the Company and its consolidated subsidiaries after all charges, including reasonable provision for taxes and renegotiation of contract prices, but before postwar and nonspecific contingency reserves.) There have been no borrowings under this agreement. In addition to the dividend paid during 1944, a dividend of $2,248,701 was declared on January 24, 1945."

27. "The indenture for the first mortgage 4% bonds of Walworth Company provides, in substance, that the Company will not de-

clare or pay any dividends (except stock dividends) on its stock unless immediately after the making of such payment either (1) the total consolidated current assets shall be at least equal to the consolidated debt (including indebtedness of every kind), or (2) the consolidated net current assets shall be at least equal to $5,000,000. Consolidated net current assets, defined in the indenture to include all the items classified as current assets in this balance sheet and certain other assets, amounted to $8,324,774 as at December 31, 1944. Under alternative (1), which is the less restrictive as of December 31, 1944, $1,847,380 of the consolidated earned surplus was not available at that date for the payment of dividends (except stock dividends) on the Company's stock.

"At December 31, 1943, by reason of the above restriction, $1,930,439 of the consolidated earned surplus was not then available for the payment of dividends (except stock dividends) on the Company's stock."

Financial-Statement Standards

Standards pertaining to various items in financial statements have appeared in Chapters V-XII. General standards such as the following must also be observed:

1. Financial statements tend to be all-purpose in character, as mentioned above, and those to which the public accountant attaches his name, notwithstanding the intention of limited circulation, must be as full and complete as though they had been designed for the world at large.
2. Where a change in accounting method has had an important effect on a financial statement, disclosure of the change must accompany the statement.
3. A disclosure may take any one of several forms: the first, which is preferred, is to include it in the body of the statement by amplifying the sidehead of the item affected; the second is to put it in a footnote; the third is to mention it in the audit report or certificate. Occasionally, a combination of these methods is followed. The footnote disclosure may be required when the subject matter is too bulky for a sidehead. Disclosure in the auditor's report or certificate is necessary where the client is unwilling to modify the financial statement—a procedure, however, resorted to only in rare instances. The disclosure should show what the item would have been, had the basis advocated by the auditor been followed.
4. The basis of valuation should be indicated in balance-sheet sideheads for all assets except cash, receivables, and deferred charges.

5. Current assets will normally include only cash and items that are likely to be converted into cash within the year following the balance-sheet date. The general standard for securities is that they may be included as current assets only if they (a) are not obligations or capital stock of the company or any affiliated organization, (b) have a clearly demonstrable, readily realizable market value, and (c) are held as a temporary investment. The cash surrender value of life-insurance policies, deposits with mutual-insurance companies, and other items readily convertible into cash, but in the ordinary course of events not to be converted into cash during the next year, should be excluded from current assets.

6. Bad-debt, depreciation, and amortization reserves, security and inventory reserves covering the shrinkage of cost to market, and other valuation accounts reflecting expirations of cost or value should appear on the balance sheet as deductions from the assets to which they relate.

7. Interorganization profits should be eliminated on consolidated or combined balance sheets and income statements, and eliminated or disclosed on single-organization statements; intraorganization profits must always be eliminated.

Representations from Client

In the final stages of the audit, after the financial statements have been prepared and reviewed, it is customary to procure from the client a series of representations concerning financial condition and operating results. These are best incorporated in a single letter but they may have to be divided when separate signatures are obtained for the different sections.

In securing representations from a client, the auditor has as his purpose three objectives: a confirmation of business practices that he has already tested; an acknowledgement from management of its responsibility for the institution and operation of over-all financial policies; and an opportunity to review with executives basic procedures with which they may not be wholly familiar, thereby more firmly fixing future top controls over such procedures.

A suggestive sample letter of representation follows. It is brief, as nontechnical as possible, contains no dollar amounts, and is confined to matters that ought to be well known to informed top officials. Amounts may be omitted in ordinary cases: most executives are too far removed from the general ledger and cannot affirm dollar amounts of their own knowledge; besides, the auditor secures a confirmation of financial-statement figures when the client's controller approves the final statements. Exceptions may be noted by adding at the end of any sentence "except for" or "except that"

followed by a summary description of the exception; or, a negative statement (i.e., on contingent liabilities) may be turned into a positive one, the exception being thus even more clearly stated. Additional signatures may be called for where important financial and operating controls reside in such officials as the treasurer and general manager, or, as previously indicated, a separate letter may be provided. The author prefers the single letter, with "subrepresentations" similar to those illustrated below.

Details should be avoided as far as possible, especially where the subject matter lies outside the normal field of activity of top management. However, independent representations of subordinates should also be avoided, for reasons already cited.

(Letterhead of client)

Hyatt, Paterson & Co.,
960 Hudson Bldg.,
Chicago 3, Illinois

Dear Sirs:

You have asked that we make certain representations to you in connection with your annual audit of our accounts for the year ended December 31, 1944.

Receivables represent uncollected sales to customers, or sums owing to the company from others, due within the coming year; the reserve for bad debts is a fair estimate of uncollectible receivables.

Inventories at the year end were based on physical count, weight, or measure at November 30, 1944, plus and minus changes during December; usable material and salable finished product were priced at the lower of cost or market, and obsolete, unusable, or unsalable items at nominal or scrap values; the inventories were clerically accurate; the company's books were adjusted to reflect the physical inventories; and title to the inventories was held by the company.

Plant-and-equipment charges during the year, valued at cost, were actual additions to property; property disposed of or abandoned was removed from the accounts; balances at the year end represent all the plant and equipment owned by the company, and on such plant and equipment the company holds satisfactory title and no mortgage or lien is outstanding.

Provisions representing fair allowances for accruing depreciation and obsolescence were added during the year to the reserves for depreciation, and the balances remaining at the year end did not exceed depreciation and obsolescence requirements at that date.

Liabilities recorded on the books of account as at the year end were the company's actual and complete obligations on that date.

No contingent liabilities existed at the year end.

No extraordinary items of income or expense appear in the income statement for the year.

During the year the company's books of account were kept in accordance with accounting principles consistent with those followed in the preceding year.

Very truly yours,

____
(Name of Client)

____
(President)

____
(Controller)

Other representations:

On inventory prices and clerical accuracy:

____
(Employee in charge of inventory-taking)

On property accounts and reserves for depreciation:

____
(Plant Manager)

CHAPTER XV

Reports

Reports issued by public accountants are of two main varieties: the "short form" and the "long form." Examples of each appear in the Illustrative Audit. Another type of audit report, ordinarily in letter form and containing the public accountant's observations on internal controls, may accompany the short-form or long-form report, or it may be included in the latter. Other types of reports follow special investigations.

Short-Form Report

For larger engagements, the short-form report, or certificate, is the general rule. A standard form is followed by most accounting firms. This form has been modified from time to time, according to whatever current emphasis has seemed desirable. The three forms in common use during the past ten years are compared on page 208; the first was generally adopted in 1934, as the result of a joint study of the New York Stock Exchange and the American Institute of Accountants, the second in 1941, after the Securities and Exchange Commission had drawn up certificate standards, and the third in 1944, following the report of an Institute subcommittee. The third form may be considered a simplification of the second; both are in common use today. The first form has largely disappeared. All three forms, however, have the same intent and meaning. To show their changes in wording, the continuous underscore indicates the language that has persisted through the various changes; the dotted underscore represents language of the earliest version, continued in the second, but dropped in the third; and the broken-line underscore represents language added to the second version and repeated in the third. Each successive form reflects an improvement in style and wording; and further improvements—even the elimination of the certificate as the public's knowledge of audit standards increases—may be expected. Nonstandard forms are often found, most of them simplified versions of those illustrated; an example appears on a subsequent page.

The accountant's report is addressed to the stockholders or to

the board of directors, according to the terms of the employment, and it is signed and dated by the accountant, following usually the style appearing in the Illustrative Audit.

Each of the standard forms contains a "scope" paragraph and an "opinion" paragraph, the former indicating the nature of the examination that preceded the certificate and giving the accountant an opportunity, by modification of or addition to the language used, to explain the nature of his work, particularly where for various reasons he was unable to apply standard procedures. The "opinion" paragraph enables the accountant, where necessary, to call the reader's attention to points on which he (the accountant) is unable to express more than a qualified opinion. One or two paragraphs, more fully explaining any of these matters, are often inserted between the "scope" and "opinion" paragraphs.

Four points are worth noting as having been repeated in each of the three forms: (a) the idea that the reader should be informed of the fact that the examination has been on a "test" basis, (b) the accountant's faith in the propriety of the financial statements is an "opinion," (c) the statements "fairly present" financial position and operating results and (d) the statements are based on "accepted principles of accounting" followed by the company. The change in emphasis between the first certificate form and the third may be summarized thus:

(1) As the reader is by now well aware, an annual audit requires a many-sided approach to the client's affairs, and it would be impossible to put every important aspect of the audit into a single paragraph. The questions that the accountant faces are how much information on scope is it practicable to furnish and how necessary is it? It will be noticed that, as compared with the 1934 certificate, the later versions omit the following statements: (a) information was obtained from officers and employees (i.e., as distinguished from information found in the records), (b) accounting methods were reviewed, (c) "operating and income" accounts were reviewed, and (d) the auditor's opinion was based on his examination. These were regarded as inevitable and obvious accompaniments of the usual form of audit, which supplied the reader with nothing he should not already know. On the question of whether mention should be omitted of the lack of a detailed audit, the profession is now divided—some believe the shorter (the third) form is an ample statement since it indicates that the examination *included* "tests" (rather than a detailed audit); others are equally convinced that further education of the average reader of financial statements on this point is necessary, and that the expression "included tests" does not adequately deny the absence of a detailed audit.

(2) In place of the reference to the consistent use during the year of accepted principles, there now appears the statement that the accepted principles followed during the year were consistent with those followed during the preceding year. This statement says as much and more: the addition being that this year's financial statements are said to be comparable with last year's; if this be true, consistency must have prevailed throughout the current year.

(3) Included in the 1941 certificate but omitted from the 1944 variation are (a) references to the review of internal controls and (b) of accounting procedures, and (c) the possible limitations attaching to the testing process through the expression "by methods and to the extent we deemed appropriate." Here again, it has been regarded as unnecessary to refer to the review of internal controls and accounting procedures, since anyone ought to know that such a review is a prime requisite to even the most limited examination. Further, an implication of conflict between the limitation described in (c) and the reference in the next sentence (see (4) below) to the following of auditing standards (which would have to be observed notwithstanding the auditor's possible conviction of their inappropriateness) was judged important enough to warrant the elimination of the former. On the other hand, accountants who still employ the 1941 certificate regard these objections as insufficient justification for so materially altering a form only a few years old.

(4) Included in both 1941 and 1944 certificates is a new sentence, at the end of the "scope" paragraph, that states that the accountant observed "generally accepted" and applicable *auditing* standards plus such other procedures as were deemed "necessary" by him. In the 1944 version the reference to "testing" is included at this point.

(5) With the immediate origins of the third form in mind, its meaning may be summarized thus: the "scope" paragraph states that relevant auditing standards were observed in the examination, which included tests and other necessary procedures; the "opinion" paragraph states that the public accountant believes that the financial statements are a fair presentation, consistent with the previous year's. By omitting references to internal controls and the other matters described above, the public accountant does not thus deny their importance; rather, he omits what is common knowledge to all who read and depend on financial statements.

The certificate standards of the Securities and Exchange Commission, previously referred to, may be found in Rule 2.02 of Regulations S-X, which provides that the certificate must contain (a) a "reasonably comprehensive" statement of the audit scope, (b) a

1934 Version	*1941 Revision*	*1944 Variation*
We have examined the balance sheet of the X Company as of December 31, 194–, and the statement of income and surplus for the year then ended. In connection therewith, we examined or tested accounting records of the company and other supporting evidence and obtained information and explanations from officers and employees of the company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.	We have examined the balance sheet of the X Company as of December 31, 194–, and the statements of income and surplus for the year then ended, have reviewed the system of internal control and accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and it included all procedures which we considered necessary.	We have examined the balance sheet of the X Company as of December 31, 194–, and the statements of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and it included such tests of the accounting records and other supporting evidence and such other procedures as we considered necessary.
In our opinion, based on such examination, the accompanying balance sheet and related statements of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under review, its position at December 31, 194–, and the results of its operations for the year.	In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the X Company at December 31, 194–, and the results of its operations for the year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.	In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the X Company at December 31, 194–, and the results of its operations for the year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

statement indicating whether "normal" auditing procedures and "generally accepted," applicable standards have been followed, and (c) where any procedure deemed necessary by the accountant has been omitted, a statement to that effect, with the reasons for it. The accountant is instructed to review the accounting procedures actually followed and, in determining the audit scope, to give such weight to internal controls, including internal auditing, as they may warrant. As to the second half of the certificate, the Commission requires that it contain the accountant's opinion of (a) the financial statements, (b) "any significant change in accounting principle or practice, or any significant retroactive adjustment of the accounts of prior years," along with a description of the change or adjustment and of its effects on the comparability of the statements, and (c) "any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review." At present, these requirements appear to be fully met by either the second or the third certificate forms above quoted.

The trend toward certificate simplification and the gradual acceptance of the assumption that the reader no longer needs to be informed of details of audit scope leads naturally to the question "Cannot the certificate be simplified further?" The answer is that it undoubtedly will undergo further simplification and ultimately may be eliminated altogether. The author favors a certificate similar to the following:

> In our opinion the accompanying balance sheet and income statement present the position of the X Company at December 31, 1945, and the results of its operations for the year then ended.

No scope, adherence to auditing standards, or reliance on tests is indicated, and no reference is made to the continuance of last year's accounting principles; only a simple statement of opinion appears, which is all that the reader of financial statements pays attention to, anyway. If members of the profession can be relied on to report their deviations from auditing standards and their clients' deviations from accounting principles whenever they occur, the simpler the basic structure of the short-form report, the better.

Certificate Exceptions

Following are examples, taken from published corporate reports, of the additions that public accountants make to the standard certificate forms. For the most part, they may be described as qualifications or exceptions.

Irregular accounting procedures.

1. "In accordance with the plan of accounting previously followed by the companies . . . profits on sales of metals in the net amount of $188,836.59 during 1944 were credited to contingent reserve for metal fluctuations, and inventories of unsold metals have been valued consistently at market prices prevailing at time of production or at the end of the year, whichever are lower. This method of accounting, in our opinion, is acceptable, although under alternative practice such profits might be included in profit and loss. . . . In our opinion, subject to the remarks in the preceding paragraph, the accompanying balance sheet . . ."

2. "The practice of the Company in computing its net income or net loss without deduction for depletion of metal mines is in accordance with accepted accounting practices and procedures in the industry engaged in the mining of copper, and is in agreement with long established and consistently maintained accounting practices and procedures of the Company and others similarly situated, and the Company is advised by Counsel that such procedure is in accordance with legal requirements."

3. "In general, the subsidiary companies follow the retirement reserve method in providing for plant retirements. The provisions for retirements are based, in general, upon rates per kilowatt hour of electric sales and per thousand cubic feet of gas sales and for depletion on rates per thousand cubic feet of gas produced or sold. These rates have been changed when, in the judgment of the management, such changes were necessary to meet reserve requirements. Information is not available, in most cases, to compare the amounts provided under this retirement method with those which would be determined by depreciation and depletion methods of accounting but preliminary studies for certain subsidiaries indicate that the reserves for such companies are in excess of amounts which would have been provided under depreciation and depletion methods of accounting by approximately $8,500,000."

4. "As indicated in Note 1 to the financial statements, inasmuch as the property account has not been classified with respect to cost of properties acquired as entities so as to allocate such cost to units of tangible properties and to intangibles, it is not known to what extent, if any, subsequent credits for property sold or retired on the basis of estimates, have been different in amount from the portion of total cost attributable to such properties. . . . Except for the effect of the matters described in the preceding para-

graph (the amounts of which are not known), in our opinion, the accompanying balance sheet . . ."

5. ". . . applied on a basis consistent with that of the preceding year except for the change, which we approve, in respect of depreciation and amortization explained in Note 6 of the notes to accounts."

[Note 6 read as follows:]

"For the year 1944 depreciation was provided on certain facilities . . . at rates determined in accordance with the Corporation's regular depreciation policy, whereas, in 1943, amortization of these facilities was provided at the annual rate of 20%. This change in practice has the effect of decreasing the provision for depreciation and increasing the net income for the year by approximately $1,200,000."

6. ". . . accepted accounting principles applied on a basis consistent (except for the change, which we approve, of charging special provision for fire losses to income for 1944 rather than earned surplus as was done in prior years) with that of the preceding year."

Changes during year in accounting procedure.

7. "In 1943, an amount written off cost of properties acquired, to give effect to appraisal or book values of such properties, was charged against capital surplus. A similar write-off in 1944 with respect to properties acquired was charged against earned surplus. We approve this change in procedure."

8. "Of the reserve for revaluation of investments, which had been set up in prior years by charges against surplus, $5,000,000 is no longer required and has been transferred to surplus. As the book value of these investments is less than their indicated market value at December 31, 1944, the balance of the reserve, $8,038,-850.66, is included among reserves on the liability side of the balance sheet."

Limitations on audit coverage—foreign branches.

9. "We accepted, after review, the financial statements of the Canadian subsidiary as certified by independent auditors. The accounts of that subsidiary were taken into the Consolidated Balance Sheet upon the following basis: net current assets converted into U. S. dollars at the official rate of exchange on December 31, 1944 and the other net assets at the prevailing rate of exchange when acquired."

10. "We were furnished with financial statements certified by chartered accountants for the subsidiaries in Great Britain and the West Indies. . . . In our opinion, based upon such examination and upon such reports of other accountants . . ."

11. "The accounts of foreign subsidiary companies . . . have been brought into the consolidated financial statements on the basis of company reports which, because of war conditions, we have not yet confirmed by the year-end examinations now in progress, although we have received cable advices that there is no present indication of any substantial adjustment of these reports."

12. "Due to war conditions it was impossible to make any recent audit of the Company's foreign subsidiaries and branches, as to which we were compelled to rely to a great extent on reports and cable advices received from officials abroad. . . . The aggregate amount at which the Company's entire foreign investment is carried in the consolidated balance sheet after applying the balance in the reserve for contingencies (affecting foreign assets) is approximately $42,000,000 or 6% of the total equity of the stockholders of the company. . . . In our opinion, subject to the limitations of our examination explained above . . ."

Comments on examination of receivables.

13. "It was not practicable to confirm receivables from agencies of the United States Government with respect to which we have satisfied ourselves by means of other auditing procedures."

14. "Receivables from departments and agencies of the U. S. Government and from certain other customers were not confirmed but we satisfied ourselves by other means as to these items."

Comments on examination of inventories.

15. ". . . our examination . . . comprised all procedures which we considered necessary, including observation of procedures followed by the companies at various times during the year in determining physical quantities of the principal inventories."

16. "Due to war conditions, it was not practicable for the Company to check the book values of work in process at one of its principal plants (which was carried at approximately $17,000,000 at December 31, 1944) against a valuation based on physical inventories thereof. From our review of the records supporting such book values, we believe that they are not in excess of the lower of cost or market."

17. "Our examination of inventories included observation of coal stored on the principal docks of the companies, observation

of the procedures followed by company employees in determining merchandise inventories on hand at selected locations as of December 31, 1944, and selected test-checks of supply inventories."

Contingent liabilities.

18. "The amounts of the adjustments, if any, in respect of 1943 and 1944 which may result from renegotiation under War Profits Control legislation of certain contracts and subcontracts and from settlement of certain accounts with U. S. Government departments and agencies, cannot be determined at this time. . . . In our opinion, except for the effect which the adjustments, if any, mentioned in the preceding paragraph may have on the accounts . . . generally accepted accounting principles applied, in all major respects, on a basis consistent . . ."

19. "Various suits involving substantial amounts are mentioned in Note 4 to the financial statements. The effect of the adjudication of such suits upon the financial position of the companies cannot be determined at this time."

20. "While provision has been made for the estimated income and excess-profits tax liabilities of the companies, the adequacy of the provision is, of course, dependent upon the acceptance by the tax authorities of the returns of the companies."

From these samples the reader will observe that:

(a) It is not always clear whether the accountant means to give information to the reader or is simply endeavoring to protect himself from possible liability should he fail to call attention to accounting and auditing departures from the normal. Thus, in illustrations 15 and 17, the phrases quoted seem to have as their purpose the giving of information, possibly with respect to procedures followed by the accountant for the first time. But the effect on the reader, especially in the latter illustration, might well be to give him an impression that the examination of the inventories was limited and therefore defective. If, for some reason, the accountant finds it necessary to mention a procedure in his certificate, his opinion of its adequacy should also appear. In the present instance, the chances are that it would have been better if the sentence had been omitted entirely.

(b) Even where it is clear that the accountant means to question the rightness or wrongness of a principle or procedure, the quantitative effect on the financial statements may be overlooked. Thus, in illustration 20, the inference is that the company may have underprovided for income and excess-profits taxes, but the amount of the contingency does not appear and the reader is left

in doubt as to the real significance of the accountant's comment. If the accountant has no opinion of the amount involved, he should say so. Putting the reader on notice should include giving him the likely financial effect, if worst comes to worst. Occasionally, the accountant claims that mention of the amount of a contingent tax liability may serve as a signal for an additional assessment from the authorities. It has been the author's experience that there is no merit in this point of view, although it is often encountered, in management as well as professional circles.

(c) In the opinion paragraph, "except for" (e.g., illustration 18) seems to have fairly well replaced "subject to" (e.g., illustration 12) where it is the intention to qualify the opinion. The latter phrase has often been criticized as not adequately indicating the accountant's intention, since it was never clear to what word the adjective "subject" was intended to relate. "Except," a preposition, seems to lend a little more clarity to the picture in that it definitely indicates a limitation of the accountant's opinion.

(d) Possibly the reader has already noticed the limited character of the language employed in certificates. The style, patterned after a few set forms, is often crabbed, and, in striving for economy and accuracy of words and for euphony as well, the accountant may succeed in being only technical and vague. The accountant must always endeavor to avoid strictly professional language, for his certificate must be understandable to nonaccountants if it is to succeed in its purpose. In phrasing his exceptions, he should put himself in the position of the persons who will interpret them. For example, in both forms of the certificate in current use are twice-repeated modifiers, "generally accepted"; these words tend to puzzle the average reader, for the meaning of "auditing standards" and "accounting principles" would be the same without them.

Long-Form Report

Occasionally, the published reports of accountants contain brief outlines of the audit scope, sandwiched between the two standard paragraphs above described. A good example may be found on page 6 of the 1944 annual report of General Electric Company to its stockholders. The added material, consisting of approximately 500 words, refers to balance-sheet items only; thus, a paragraph on cash and securities reads typically as follows:

> We confirmed the cash and securities by count and inspection or by certificates obtained from the depositaries.

This is intended merely to convey information to the reader; actually its value is questionable since, being in an out-of-the-ordinary certificate, it raises the question of regularity.

Another type of long-form report may be found in the Illustrative Audit. It is usually a supplementary report issued at the same time as the short-form report or later and in most cases is addressed to directors or officers. It serves to put into brief compass the outstanding events of the year so that they may be referred to and quickly interpreted in future periods. Although the forms of the balance sheet and income statement are likely to be the same as those appearing in the short-form report, the number of financial statements may be considerably expanded by including schedules such as analyses of sales and cost of sales, summaries of changes in fixed assets and reserves, and details of certain accounts. Quite frequently the long-form report is planographed or otherwise reproduced and given a limited circulation outside the business—among financial analysts and others who raise questions of detail that such a report can answer. Or a similar report may be prepared by the controller and reviewed by the public accountant; it will not contain the certificate paragraphs, but will consist primarily of schedules supporting balance-sheet and income-statement items, and, in the case of consolidated statements, a consolidating worksheet, and summaries of eliminations and other details that are helpful in understanding the method of preparing the statements.

The long-form report issued for internal and limited external use is of frequent occurrence in connection with engagements of medium size, where the accounting talent available may lack the ability, confidence, or time to do the job itself. Like the financial statements, it is preferably prepared and reviewed in the client's offices where additional information can be readily procured and where statistical details that are not obtained as the result of ordinary audit procedures are available or can readily be verified. The following outline is often observed:

Narrative:

Introduction, including index to financial statements
Results from operations
Balance sheet
Changes in financial position
Internal controls
Special comments

Financial statements and analyses:

Balance sheet
Analysis of changes in property and depreciation—reserve accounts
Analyses of other balance-sheet accounts
Income statement
Detailed cost of sales, departmentalized or by products, quantities, and unit costs
Selling, general and administrative expenses
Operating statistics

The scope and detail will vary with the indicated desire of the client. Where long-form reports have been issued for a number of years, the accountant will have had numerous opportunities of studying the interests of those who make use of it; he will endeavor always to meet those interests and to direct attention to new events and trends that should be of significance to the readers of the report. In most cases the auditor will be instructed by his principal as to report content, but the auditor will usually be allowed a good deal of freedom in modifying the content and emphasis as he sees fit. Accounting principals always endeavor to stimulate and encourage the originality of staff members who show competence in writing reports.

Introduction. A long-form report is preferably addressed to the Board of Directors; or it may be addressed to the president or other officer, with an indication in the address of his title. The report should, like the short-form report, bear the date that signalizes the point to which the post-audit-period scanning was carried. The introductory paragraph may be a reproduction of the "scope" paragraph of the short-form report. Sometimes a more descriptive indication of the audit is given but this is unnecessary. An index should appear at this point; or it may occupy the whole of a preceding page—a preferable procedure where the report is extensive and covers many items.

If limitations of any kind have been imposed on the audit by instructions from the client or by limitation of available data, they are preferably described rather fully in the introductory section.

Operations. At the beginning of the operations section, it is usual to present a brief comparative summary of the income statement—this year's and last year's, perhaps more than one prior year's, with columns for increases and decreases and for percentage relationships to sales. This is the sort of statement which, at least in tentative form, the auditor should have well in mind at the time of his inquiries on operations (pp. 53-60, Chapter V). By the time he is ready to write his report, he should know the causes of fluctuations as between months and years and be able to summarize the current trends, at least as they seem to be reflected in the accounts. Major changes in selling prices, unit material, labor, and overhead costs should be carefully and accurately explained.

A few accountants, although rigorously avoiding adverse criticisms of management's conduct of operations, are in the habit of complimenting the management where the operating results or financial conditions within the business have improved during the year. This attitude deserves unqualified condemnation. Personalities have no place in an accountant's report. This does not

mean, however, that the accountant should avoid adverse criticisms of management and accounting practices. The accountant's general experience in these matters makes his comments worthy of record in annual reports at all times; but they can always be forcefully couched in factual, impersonal language.

Some accountants have become specialists in certain fields and their reports on operations may be much more than ordinary audit reports. Whatever comparable data the accountant has available on other similar enterprises, which he has acquired as the result of professional relationships, must, of course, be kept confidential, unless, as it often happens, some or all of these have been made matters of public record and have, therefore, lost their confidential status. But whether or not he is able to call attention to outside information, his knowledge of cause and effect within the industry will stand him in good stead in analyzing the affairs of any one representative of the industry.

Balance Sheet. Neither the operating nor balance-sheet section of the report need define the details of the audit scope unless the accountant has found the management interested in such a matter. In the average situation what seems to be of primary interest to management is the underlying significance of the accounts. The accountant has the opportunity in the balance-sheet section to present compact but revealing summaries of account content and their meaning to the enterprise. Following are typical points covered in this section:

Cash: activity in bank accounts, relative costs (service charges), transfers during year, safeguards over use.

Receivables: separation by notes and accounts if but one figure appears on the balance sheet, sources, aging, characteristics of employee loans, officers' accounts, expense advances, etc., adequacy of bad-debt reserve, rate of turnover.

Inventories: Summary by principal classes, locations, methods of count, periodic (internal) verification, turnover of different classes, excess stock, high-cost stock, adequacy of repair parts, nature of inventory out on consignment.

Fixed assets: analysis of changes during year, summary of principal new items purchased and old items retired, questions of capitalization, repair ratios for various years, reserve ratios, rates of depreciation—their adequacy, changes during year, comparison with last revenue-agent's report, nature of studies now needed of reserve adequacy, nature and extent of standby equipment, comments on retirement program for next year or years and required investment likely for replacement needs, propriety of present work-order procedure.

Liabilities: cause of change during year in working-capital ratio, discounts missed, large unpaid items, changes in credit terms, compliance with bond-indenture requirements, advances from others on contracts or for other reasons, detail of bank loans

outstanding, analysis of deferred credits, transactions charged and credited to liability reserves.

Financial position. Changes in financial position, in most instances best portrayed in a statement of (application of) funds, is always closely studied by management. It may be preceded by condensed comparative balance sheets at the beginning and end of the year, with comments on the leading differences.

Internal controls. A summary of the auditor's review of internal controls—the subject matter of Chapter IV—can be set forth at this point. Sometimes the auditor's comments on internal controls are separated from the rest of the report and made the subject of a special letter, because interest in such comments is usually confined to a much smaller group within the organization, and because of the likelihood of a misunderstanding of their significance on the part of persons not actively engaged in making internal controls more effective. However, these are not ordinarily strong reasons and most long-form reports contain internal-control comments.

A letter on internal controls may also be written where there is no long-form report, this being standard practice on many larger engagements.

Emphasis by the auditor should be put on policies and other matters that he believes should be of major concern to top management—new management policies instituted during the year and how they were carried out, old policies not well enough enforced and suggestions for strengthening them, old policies formally dropped, hitches in delegations of authority, comments on stockholder and board policies or on matters that might be made stockholder or board policies, comments on changes in general controls exercised by top management, criticisms of present accounting and financial policies with suggestions for changes, comments on the internal-audit function and its relation to the work performed by the public accountant.

Special comments. Under the heading of special comments would come observations, if any, as the result of the auditor's detailed audit for limited periods during the year. These may be of sufficient importance to make them a matter of formal record in the report; otherwise, they should be disposed of informally by discussions with persons directly concerned, and that general fact recorded at this point.

A summary of the insurance in force may be presented here.

Conclusion. The traditional concluding paragraph is an expression of "appreciation of coöperation" on the part of the client's staff.

Practical Suggestions in Writing Reports

The following suggestions have been of value to accountants who have experienced difficulty in expressing themselves in reports:

Place yourself in the client's position. Study the person or persons for whom the report is primarily intended and try to form some idea of the kind of report that will appeal to them. Some relish details; others do not.

Use unambiguous, concise English. An ability to express ideas clearly and in good form is, indeed, a fortunate possession. Long sentences should be avoided; on the other hand, short sentences may be hard to follow. Avoid beginning sentences with "the." Good paragraphing is a distinct aid to the reader, and the use of captions for each section of the text likewise facilitates comprehension of the facts presented. Avoid redundant expressions.

Do not be stereotyped. Many accountants fall into the habit of making stereotyped comments on the various items in the balance sheet. The same comments, repeated each year, are certain to kill the client's interest in the report; they indicate a dull and unimaginative accountant as well.

An auditor cannot escape discussing facts. They must be presented regardless of whom they hurt. But diplomatic language may be employed in imparting information.

Omit unimportant detail. Small differences may exist between the trial balance of a subsidiary ledger and its controlling account and this is known to be a clerical error; or the petty-cash fund may be short 13 cents. However, these are matters too trivial for a serious report. Nevertheless, if they *must* be mentioned, let the narrative be as brief as possible.

Make the text interesting and readable. Businessmen may often be concerned with particular financial or operating problems. Cover them thoroughly if their importance warrants. The use of ratios, statistics, and charts may help the accountant materially in getting his ideas across. Facts that point to likely future trends should be emphasized, but definitely without a trace of forecasting. Let the reader draw his own conclusions.

Write the text promptly. The text of a report should, wherever possible, be written on the job, even in sections, as has been previously mentioned, while the audit is still in progress. Deferment of the drafting until the auditor has been given a new assignment means that many a point that would have added both interest and value to the report will have been forgotten.

Give reasons. If a comparison of balance sheets or operating results is being made, mere statements that certain increases or decreases have taken place are insufficient unless reasons accompany

them. Many an accountant has made an excellent analysis in schedule form, only to forget to set forth in the text the reason for their preparation. Explanations and conclusions must be presented in connection with each summary; otherwise, there will be no justification for its inclusion in the report.

Be certain of your spelling. Names of persons, towns, and technical terms had best be printed by the auditor in the draft of his report to prevent typing errors. The handwriting of many persons, including most auditors, can sometimes be read at a later date by themselves and others only by the context.

Report Typing and Referencing

Typists who specialize in reports and financial statements will, unless otherwise directed, follow a uniform pattern established for their office in the setting up of headings, sideheads, dollar-signs, single and double underscores, margins, and other mechanical details which are essential to the make-up of every finished page. Deficiencies in the drafting are often detected and remedied by the typist supervisor. However, younger auditors should always avail themselves of opportunities of studying the forms and drafting devices of more experienced members of the staff, in an effort to make their own output superior in every respect and to help the typists in their work of adaptation. When a difficult form is to be reproduced, the auditor should learn how to count typewriter spaces, horizontally and vertically, and indicate them on his draft, so that he may conform his copy to page limitations. "Close" rather than "open" typing is always to be preferred in schedule work whether in the body of the text or in separate exhibits, with but one or two spaces between money columns, even though wide margins result. In larger schedules, each sixth horizontal line may be left blank in order to aid the eye in following across the page. Column headings, and their hyphenation, should be studied carefully so that there may be a good "fit" in a limited space. The auditor should never be above experimenting occasionally on the typewriter himself with the set-up of a difficult exhibit. He should always bear in mind that schedules can almost always be improved in style, thereby making them more attractive and readable to the person for whom they are intended. A little extra attention paid this year to a schedule the form of which will be repeated next year is always worth the effort.

Larger public-accounting firms maintain a "referencing" staff skilled in verifying, from the working papers, figures, statements of fact, spelling, dates, places, and other matter going into reports and financial statements. Smaller firms assign senior accountants temporarily to such work. The referencing is done usually by a

team of two immediately after the typing operation is completed. A referencing sheet is prepared on which proposed changes are noted by the referencers; the changes are subsequently reviewed by the auditor and his principal and approved, modified, or eliminated, after which the material is returned to the typist for correction or rerun; a second inspection is thereupon made by the referencers and cleared through the principal. Usually a final inspection is made of the report text and exhibits after all corrections have been made; the report is then bound and signed, ready for delivery to the client.

Delivery of Report

Circumstances permitting, delivery of the report should be made in person by the principal, with the auditor present also, so that the main points of the report may be again discussed with the client's representatives—and amplified, where necessary. Such discussion may lead to immediate action on the accountant's recommendations, and pave the way for discussing the audit scope of next year's examination and for agreement upon the approximate date of preliminary work. It may be that another visit by the principal to the client's office will be warranted at a later date to ascertain whether the recommendations suggested in his report —or their equivalents—have been put into effect. It is at this time, following the delivery of the report, that an audit program for the coming year may advantageously be prepared by the principal, with the help of the auditor.

Limitations on the circulation of the accountant's long-form report should never be attempted, at least by the accountant. He should always be able to back up what he has said, regardless of the connection with the management of the person who reads his report. The client's officials may wish to give it limited circulation within the organization, but this should be discouraged, whenever practicable, since subordinates interested in over-all management and accounting policies, who might otherwise not be given the opportunity of studying the accountant's criticisms, are often able to devise ways and means of instituting needed changes with the maximum of effectiveness and a minimum of shock to the organization.

Questions on Auditing

1– 1 What is the meaning of "independence" as applied to the independence of accountants? Cite examples of the lack of independence, and rules of professional conduct prohibiting actions that might result in impairment of an accountant's independence.

1– 2 Discuss briefly five rules of ethics that have been established for professional accountants and indicate which of them you believe to be the most important.

1– 3 Outline the requirements for the CPA degree in the state in which you live.

1– 4 What legal risks would an individual incur if he held himself out to the public as a professional auditor under each of the following conditions: (a) he has properly qualified under the laws of the state as a CPA but has had no experience in the field in which he has accepted engagements; or (b) he has not qualified as a CPA in any state but has had experience as an auditor?

1– 5 Discuss a number of the general characteristics of an annual or balance-sheet audit.

1– 6 Wherein do the functions of the auditor and accountant differ?

1– 7 What is the general meaning (i.e. outside the field of auditing) of "sampling" and "testing"?

1– 8 Why is advertising on the part of the members of the professions of law, medicine, and accounting regarded as unethical?

1– 9 Why should professional custom rather than individual judgment be regarded as a guide in determining the meaning of facts regarded as essential from the legal point of view? Does this mean that in unusual cases, where precedent is lacking, individual judgment is also to be disregarded?

1–10 What is meant by the term "third persons" when referring to the accountant's liability in performing audit services, and who is likely to be included under such a head?

1–11 Discuss the possible connection between the budget of a business enterprise and the annual audit of the enterprise by the professional accountant.

1–12 Rule 5 of the AIA rules of professional conduct forbids a member from expressing an opinion on financial statements where his "exceptions" have the effect of negativing his opinion. List a number of imaginary situations which, as you understand it, might give rise to this type of exception.

1–13 In rule 9 of the AIA rules of professional conduct, a prohibition appears against contingent fees except in tax cases. Why do you suppose the prohibition was not extended to all professional compensation?

1–14 What justification lies in the prohibition against the certification of estimated future earnings?

1–15 What difference in the degree of legal liability arises from an auditor's "mistake" arising from (a) ignorance of ordinary audit procedures, (b) an error that even the best of auditors occasionally makes, and (c) a client's influence on the auditor to do a certain thing that most auditors would characterize as "bad accounting"?

1–16 In the definition of "audit," reference is made to the "propriety" of financial statements. Indicate several characteristics of financial statements that this word suggests to you.

1–17 Name six major elements which you would like to see featured in every income statement, and six types of items you would exclude from the income statement.

1–18 Outline briefly your present understanding of the importance of internal controls to the auditor.

1–19 During preliminary conversations with the management of a new client, (a medium-sized manufacturing company) you learn that the accounts are in poor condition. You quickly acquire substantial evidence of careless vouchering, books out of balance, inaccuracies in the taking and pricing of physical inventories, failure to carry through on discovered errors, and internal reports six months or more in arrears. The management disclaims responsibility for the situation, and lays the blame on the previous auditors who appear never to have submitted any complaint, written or oral, dealing with these matters. Aside from the appointment of a new controller, what responsibility should attach to the top management with respect to the specific conditions you have encountered?

1–20 Would you classify the absence of a good cost system in a manufacturing establishment as the consequence of a poor management policy or of a poor accounting policy?

1–21 A client has sent a public accountant the journal, general ledger, and paid vouchers relating to a joint venture now closed, and has requested that an audit be made of these records. What additional information do you suppose the public accountant would be likely to ask for before completing his examination?

1–22 Weaknesses in administrative ability have been observed by an accountant in the top management of a business firm he is auditing. In what way may the scope of his audit be affected?

1–23 You have before you the comparative profit-and-loss statements for the past two fiscal years of a manufacturing enterprise. Discuss briefly the truth or falsity of each of the following propositions relating to these statements:

(a) Each item of income and expense of the later year differs by not more than 5% from the corresponding item of the earlier year and the net profit comes within 2%; hence, since the accountant, a year ago, audited the income and expense accounts of the earlier year, he does not need to examine the later year's income and expense accounts.

(b) The management was unusually efficient in maintaining operations at so nearly the same level.

(c) No new policies affected operations during the later year.

(d) Although a new product line was introduced during the later year, it had no effect on earnings.

(e) A difference of only 5% in gross volume indicates that the business has reached a stable level of production.

2- 1 What are some of the standards an auditor should follow in preparing each working paper in an annual audit?

2- 2 Examine a number of the worksheets of the Illustrative Audit and describe the practice followed with respect to title, date, source of information, and cross reference to other sheets.

2- 3 What safeguards should surround the acceptance by the auditor of worksheets prepared by the client's staff at his request?

2- 4 Examine the "agenda" sheet in the Illustrative Audit and set forth the classes of items you find on it.

2- 5 Distinguish between adjustments and reclassifications. Should reclassifications appear on the books of account?

2- 6 Describe a process whereby the auditor may eliminate most formal reclassifications.

2- 7 What do you conceive to be the elements that should go into every carefully prepared adjusting journal entry appearing in the auditor's working papers?

2- 8 What are the various purposes served by a permanent file?

2- 9 Describe briefly the two principal methods by which an account may be "analyzed."

2-10 Outline the general process followed by the auditor when he "tests" or "scans."

2-11 Prepare a summary of the index letters and numbers used in the Illustrative Audit.

2-12 Under what conditions might it be desirable to maintain a permanent-file section on cash?

2-13 The following is summarized from an auditor's analysis of the sales account of a client for a recent fiscal year (the phraseology and figures are the auditor's):

Sales this year to customers	$3,047,695.80
Prior-year sales not accounted for in the last year's receivables as an addition or in last year's inventory as a reduction	26,125.43
Scrap sales	4,244.26
Total credits in sales account	$3,078,065.49
Returns of last year's sales	$ 80,427.60
Returns of this year's sales	52,781.11
Bad-debt writeoffs on—	
Prior-year sales	3,268.08
This year's sales	1,530.00
Cost of operating credit office	30,135.63
Small items (under $1,000 each), too numerous to look for; but ran a tape which gave a total of	101,687.97
Total debits in sales account	$ 279,830.39
Balance—OK per trial balance	$2,798,235.10

Comment on the analysis, the need of adjustments and reclassifications, and the desirability of securing additional information.

2–14 What disposition should be made by an auditor of each of the following conditions discovered by him during the course of a calendar-year audit:

The general-ledger debits exceed the general-ledger credits by $110.00.

The customers'-ledger bookkeeper has "plugged" his trial balance by 20 cents in order to secure an agreement with the general-ledger control.

Factory-overhead allocation during the year was changed from a labor-hours to a labor-cost basis.

The office payrolls were not tested by the internal auditor this year although he made thorough tests of such payrolls last year.

Bank-service charges of $1.78 for December were recorded as an expense of the month following.

2–15 An auditor's working trial balance is sometimes referred to as the "key" to his audit. Examine the working trial balance appearing in the Illustrative Audit and describe its relationship to (a) the books of account, (b) the working papers, and (c) the financial statements.

2–16 A petty-cash reimbursement voucher, dated in January of a calendar year under audit, and another such voucher, dated in December of the same year, have been carefully examined by an auditor and have been found to be in good order. May the auditor then conclude that any testing of such vouchers for the balance of the year would be superfluous?

2–17 In scanning an account, an auditor pays attention to the possibility of "faulty explanations accompanying postings." What importance would you attach to inaccurate explanations?

2–18 During an audit it is discovered that numerous changes have been made in the classification of expense accounts. What attention would you give to such changes, and what result might they have on the financial statements you prepare?

2–19 Discuss briefly the meaning of the instruction: "Depend as infrequently as possible on the client's written procedures and on oral statements made by the client's staff."

2–20 A recurring problem in audit field work is the disposal of small items. On a certain engagement during the past year an auditor reports to his principal that he discovered the following items but regarded them as unimportant and hence took no steps to correct them:

(a) Folio references frequently missing in general ledger.
(b) Erasures of postings, claimed by bookkeeper to be clerical corrections.
(c) Adjustments made directly by debiting and crediting general-ledger accounts, not supported by journal entries.

Do you agree?

3– 1 State the auditing procedures that might be undertaken before the balance-sheet date in the case of an industrial concern.

3– 2 Is it the duty of the auditor to balance the books or to make adjusting entries of any kind in his own hand on the books?

3– 3 Set forth the elements of a well-planned audit program.

3– 4 Explain what method you would use in keeping your working papers properly filed and under control during the course of an audit.

3– 5 What are the principal objects for which an auditor's working papers are made and preserved?

3– 6 What position would you take if a client demanded your working papers after you had completed your audit?

3– 7 Give at least three reasons why most auditors regard it as important that an adjusting journal entry be prepared promptly when an error is discovered.

3– 8 In auditing the accounts of a corporation for the first year of its existence, what records and documents would you expect to examine in addition to the books of account and vouchers?

3– 9 Does a trial balance furnish conclusive evidence of the absence of clerical errors in the accounts?

3–10 When an auditor, employed to examine the accounts of a manufacturing enterprise, finds that the current work is far behind and that no trial balance has been taken of the general ledger in more than a year, what course should he follow?

3–11 What responsibility should an auditor assume for the opening balance sheet in a first engagement—where previous audits have been made by other firms of public accountants having a high professional standing?

3–12 Many accountants observe a formal procedure in making their annual arrangements with clients. One accountant, for example, prepares a letter for his client's signature, in which appear such details as audit scope, provisions for advance billings (relating to fees), nature of the audit report, and date of delivery. Another accountant maintains the necessary personal contacts with his clients, and he and his fellow principals often enter into audit arrangements over the telephone without any interchange of correspondence. Discuss critically these two extremes.

3–13 Do you believe that a professional accountant should accept an audit engagement under any of the following limitations:

(a) Access will be given to journals and ledgers but not to original documents, such as paid vouchers.

(b) Access will be given to all bookkeeping records and supporting papers, but the auditor will not be permitted to question or consult with any employee.

(c) The only limitation placed on the auditor's activities is that he will not be allowed to talk to employees outside the controller's office.

(d) The auditor will not be permitted to modify in any way the financial statements presented to him by the management, although no impediments will be put in his way in the conduct of his audit, and there will be no objection to any qualifications he may wish to include in his certificate or report.

(e) The only restrictions imposed are that there must be neither an examination of the cashbook nor a reconciliation or verification of a certain two out of five bank balances.

Give reasons in each case.

3–14 Where an auditor is chosen by the management for the regular annual examination and report on the books and records, would his primary responsibility be different if he were chosen by a committee of the directors or by vote of the stockholders?

3–15 A wood-products manufacturing company has asked the Second National Bank for a line of credit of $500,000. The bank is disposed to grant the request but has called on a local public accountant to "survey" certain matters relating to the company, without making a formal audit. The books of the company have been examined each year by a reputable accounting firm. The bank's credit officer explains to the accountant that the bank expects the company to liquidate its loan at least once annually and so to manage its affairs that it will be free from debt (to the bank) for at least 4 continuous months each year. The matters designated by the bank for "survey" are as follows:

Inventory
Depreciation
Cash balances
Receivables
Surplus
Reserves

Prepare for each of the above items a list of specific questions to which you believe it would be desirable for the auditor to find answers in order to satisfy the bank's need for information.

3–16 A professional accountant, following the delivery of his audit report to a client, is asked by the chairman of the board of directors to attend a board meeting and there to explain in simple language the meaning of the following terms which they have found in the report:

(a) Depreciation
(b) Earned surplus
(c) Commitment (involving a contingent liability)
(d) Working capital
(e) Internal controls
(f) LIFO (last in, first out)

You are called upon to suggest a paragraph of explanation for each of these items, in accordance with the board's request.

3–17 A statement often repeated is that "the accountant is not a valuer." Explain.

3–18 A retail store is changing hands and the parties involved have agreed among themselves that a public accountant will be called in in order that the exchange price will be equal to the "net worth of the business, determined in accordance with good accounting practices, without allowance for goodwill or other intangible asset." Because of varying accounting standards, what specific points would you suggest that the parties agree on so that the accountant may proceed with the net-worth computation?

3–19 In what specific ways do you imagine the work of a public-accounting principal is aided by a carefully worked-out audit program?

4–1 During the course of an examination of a corporation you ask the secretary for permission to inspect the minute books. He is reluctant to grant your request but offers to give you a certified copy of all resolutions relating to accounting matters. What position would you take, and how would you explain that position to your client?

4–2 You are asked to undertake a balance-sheet examination for a new client and are informed that your report will be used for credit purposes. The client informs you that all books of original entry except the general journal will be written up by his staff and that the general ledger will be posted therefrom. He will expect you to write up the general journal, post the same, and prepare statements. What position would you take?

4–3 For what reasons does an independent auditor review a client's internal control and what two principal questions does he seek to answer in undertaking his review? Compare the extent of his review in the case of a first examination for a new client with that in the case of a client whose records he has examined regularly over a period of years.

4–4 Outline the elements of internal control you would like to see established in a well-operated receiving division of a factory.

4–5 Why are good internal controls of primary importance to the auditor?

4–6 Why does it often happen that the auditor finds operating policies in conflict with management policies?

4–7 Name and describe briefly what you believe to be the five most important accounting policies that an average business enterprise should adopt.

4–8 Distinguish between "principle" and "policy" as applied to the accounting practices of a business enterprise.

4–9 How may the professional accountant coöperate with the work being done by the internal auditor on his client's staff?

4–10 Name a number of accounting policies that, in your opinion, might well be adopted by the top management of a business and with which it should be familiar at all times.

4–11 Contrast the meaning of "internal control" and "internal check" and secure, where possible, an independent definition for each term from other texts or from some outside source.

4–12 What is the fundamental cause of the origination and continued existence of any policy affecting the internal administration of a business enterprise?

4–13 After careful study of the 20 accounting principles of the American Accounting Association, name and discuss briefly the five most important ones which you would like to see adopted by business enterprise generally.

4–14 A number of the principles referred to in the preceding question are often grouped under a single head and referred to as "the cost principle." Define "the cost principle" as best you can in a brief paragraph, without repeating any of the phrases of the statement of principles.

4–15 Expand on the meaning of the statement, ". . . conflicts with . . . the beliefs or habits of individuals may operate to decrease, modify, or even destroy the original intent [of business policies and controls]."

4–16 Sometimes the professional auditor will find accounting policies being established by committees within the accounting division of large organizations. What do you imagine are the advantages and disadvantages of this procedure, as compared with policy-forming by the controller alone or in consultation with other top-management officials?

4–17 What do you understand by the following expressions:
(a) Stock control by proxies,
(b) Minority-stockholder interest,
(c) A conflict of interests in a board of directors dominated by management, and
(d) A rubber-stamp board of directors?

4–18 "Jurisdictional problems" are frequent occurrences in almost every top-management organization. What is their nature and origin?

4–19 The general manager of a manufacturing plant tells you that he has general, staff, and departmental assistants. Contrast their probable functions.

4–20 Has a controller who reports to the president been given "responsibility without authority" where the salary scale of his assistants are established by a personnel division whose head reports to the vice-president and general manager?

4–21 Outline briefly the principal functions served by a budget.

4–22 What is meant by a "service unit" in a factory?

4–23 What elements do you think a controller's internal reporting and external reporting should have in common?

4–24 Professional accountants often say that the strongest link in a system of internal controls is a good controller. What are the principal administrative abilities they are likely to hope to find in him?

4–25 The New York Stock Exchange recommends that the controller be appointed by and report to the board of directors. What possible conflict with the general manager will this direct relationship sometimes cause?

4–26 The controller of a large manufacturing enterprise explains to you that each of five fully owned subsidiary companies has a controller who is "functionally" responsible to him and "administratively" responsible to the individual company head. Describe the meaning of this relationship.

4–27 What are the principal responsibilities you would like to see given to an internal auditor?

4–28 Systems of cash controls often provide for bank reconciliations by employees having no other responsibility for cash. Would you regard this as a proper function for the internal auditor?

5- 1 During the course of an examination you note certain disbursements have been charged to promotion expense. There is no supporting detail, but the vouchers were approved by the president. The related checks, made payable to cash, were signed by the treasurer, countersigned by the assistant treasurer, and endorsed by the treasurer. The officers refuse to furnish any further information. As an independent auditor, what would you do, and why?

5- 2 In his study of the causes of increased operating expenses of a manufacturer during the past year, an auditor discusses the following points with the management: (a) product guarantees; (b) trend of raw-material prices; (c) changes in product lines; (d) changes in production methods; and (e) methods of controlling stores. What possible expense increases might answers to inquiries on these matters help explain?

5- 3 What points do you think should be covered in the voucher-audit branch of the controller's office of a department store? Your answer should take the form of a step-by-step procedure in the processing of an invoice received from a cotton piece-goods manufacturer.

5- 4 What procedure do you think an auditor should follow in reviewing the distribution during the year of factory overhead to the several product lines, where a system of standard costs has been in use for a number of years?

5- 5 You find during the course of an annual audit that the president's salary account has been credited with a "bonus" of $5,000 for "extra service," in addition to the usual salary paid him. What steps should be taken to insure the correctness of this item?

5- 6 What of value would you expect to find, in your study of operations, in the minutes of the meetings of directors and stockholders?

5- 7 In making up a profit-and-loss statement at the end of a fiscal year, are you stating a fact or opinion?

5- 8 The president of a manufacturing company is suspected of inflating the profits of the company, his compensation being a fixed percentage of net income. Indicate a number of methods by which inflation might be effected, and the steps you would take to determine their existence.

5- 9 In examining sales expenses you find that the salaries of several salesmen and the sales manager have been materially increased during the year. The cashier informs you that the sales manager has jurisdiction over the salaries in his department, and you are shown notations signed by the sales manager, authorizing the increases in question. Would these notations constitute a satisfactory verification of sales salaries?

5–10 A firm whose accounts have been audited annually for a number of years, loses, through a fire, all its expense vouchers for the past year; its other records were saved. You are requested to make your regular annual audit. How would you proceed in connection with the missing vouchers?

5–11 A certain industrial company with several widely scattered factories has a staff officer whose title is "vice-president in charge of purchases." He is a man with extensive practical experience as a purchasing agent and he informs you that he maintains functional

controls over the activities of the purchasing agent at each plant. Outline the specific controls you would regard as essential to a satisfactory correlation of the company's purchasing activities.

5-12 Why does the accountant look with disfavor on the maintenance of accounting controls on warehouse stocks by a purchasing agent?

5-13 Accountants occasionally disagree with the general rule that quantities should not appear on copies of purchase orders going to the receiving room. If quantities *do* appear, what safeguards would you suggest to insure that the results of actual counts rather than purchase-order amounts are put on receiving tickets?

5-14 Purchasers of raw material and parts often pay invoices in advance before the receipt of the goods, especially during periods of transportation shortages. What internal-control devices does this practice make necessary?

5-15 Suggest a follow-up method for a purchaser of supplies where back orders are the rule rather than the exception.

5-16 Outline at least five controls suitable for safeguarding an active petty-cash fund.

5-17 What value do you attach to explanations accompanying postings to the general ledger?

5-18 In a certain business an average of 1200 invoices pass daily through the hands of the voucher-distribution unit. The unit consists of a clerk and 6 assistants. The clerk reports to the chief bookkeeper who reports to the assistant controller. Frequent complaints are registered to the effect that the distribution coding of fixed-asset purchases is inaccurate and requires many adjusting journal entries. List a number of possible causes for this continued inaccuracy and indicate briefly what you would do in each case to improve the situation.

5-19 The inventory-valuation methods of a manufacturing company have changed in two respects during the past year: (a) Work in process and finished goods at the beginning of the year were priced at factory cost, including factory overhead; at the end of the year these classes of inventory were priced at prime cost. (b) Raw materials at the beginning of the year were priced on the first-in-first-out basis and at the end on the average-cost basis. What effect would these changes of procedure have on operating results? Are they likely to be important enough to warrant disclosure on the balance sheet?

6–1 State the purpose of the following procedures in an examination of receipts and disbursements:
a. Foot the cashbook.
b. Reconcile bank deposits with cashbook receipts.
c. Examine paid checks by comparing date, check number, payee, and amount with corresponding data in cashbook.
d. Prove agreement between the paid checks and bank withdrawals.
e. Account by check numbers for all checks issued during a period selected for testing.

6–2 What purpose is served by obtaining bank statements and paid checks as of a date later than the close of an accounting period? State how such statements and paid checks are utilized by the auditor.

6–3 Describe a suitable distribution of duties among the accounting department, the treasurer's department, and any other department, to provide adequate protection of disbursements by check.

6–4 On its balance-sheet date a company under audit has a large amount of undeposited cash and checks received on the last day of the period. What procedure would you follow in auditing these amounts?

6–5 You are assigning an assistant to examine canceled checks relative to a client's bank account. There are certain types of checks with respect to which you urge him to be particularly alert and inquisitive. Indicate some of these types.

6–6 The cashier of a company concealed for several years a defalcation by the following process: on December 31 of each year he deposited in C Bank a check, equal to the amount of the defalcation, drawn on D Bank. He would charge C Bank on that date but credit D Bank several days later. How would proper auditing procedure have detected the fraud in an examination at December 31?

6–7 What procedures would you add to your audit program upon discovering that cash had not been deposited intact?

6–8 Give brief directions for the disposal of the following items brought to your attention during the audit of cash: (a) checks, shown as issued at year end, actually on hand on that date; (b) cash in transit to branch office at year end; (c) noncash items in petty-cash count; (d) canceled check, cleared through bank, not countersigned; (e) check, of substantial amount, to important supplier, outstanding four months.

6–9 On page 72 is an illustration of a dual bank-reconciliation schedule on December 31 and on the following January 10, with a summary of intervening details. Prepare a similar schedule for the same bank account covering the month of December, working back to what the bank totals for that month should be by assuming the following December totals on the books of the depositor: deposits, $1,275,465.44, not including $2,563.84 in transit to the bank on December 1, but including the amount in transit at the end of the month; checks issued, $1,438,662.01; checks outstanding on November 30, $36,468.38; bank charges on the November bank statement but not recorded on the depositor's books until December, $15.75. Included in the above figures for December deposits and November outstandings is a check for $1,500.00 issued by the de-

positor and returned in November by the payee because of an imperfect signature; immediately upon its receipt the check was destroyed and replaced by another of equal amount which was also recorded on the books during November, the entry for the first check remaining unadjusted until December 12, at which time the destroyed check was treated as a "deposit" in the cash-receipts book and a credit was made to the overstated expense account for November.

6–10 In the reconciliation schedule referred to in the preceding question how would you have shown the following items on the December schedule:

(a) A customer's NSF check returned in December and redeposited in January.

(b) A direct deposit made by a branch and recorded by the bank in December but not reported by the branch and recorded on the depositor's books until January.

(c) A canceled check, not the depositor's, appearing on the December bank statement, and corrected by the bank in January.

6–11 May the accuracy of a depositor's statement, received by him each month from the bank, be assumed by the auditor?

6–12 Many auditors make a regular practice of asking for duplicate deposit slips from banks covering the last few days of the fiscal year and the first few days of the following year.

(a) If the bank's receiving tellers, as so often happens, pay attention only to the totals on slips and do not verify the detail listings, is the auditor's purpose defeated?

(b) If the auditor should discover check names and amounts on a deposit slip that are not reflected in the cash-receipts book, what should he do?

(c) Many depositors no longer make use of their pass books but retain a receipted copy of the deposit slip stamped and initialed by the receiving teller. May the auditor rely on such receipted copies, and thus save the bank the trouble of reproducing its copies?

6–13 What internal control is aided by the rotation of collectors for dealers who sell on the installment plan?

6–14 Where on a balance sheet would you show bank balances representing undisbursed proceeds from the sale of a bond issue if—

(a) No restriction has been placed on the use of the funds,

(b) The proceeds may be used only for the purchase of new tank cars,

(c) The proceeds may be used only for the retirement of other long-term obligations as they mature, or

(d) The proceeds, although not restricted by agreement with bondholders, are to be applied to the reduction of current obligations so that full advantage can be taken of cash discounts, in accordance with a resolution of the board of directors.

7- 1 A large retail establishment writes off certain customers' accounts and notes by a charge to Reserve for Bad Debts but maintains a memorandum ledger for the accounts so charged off. State the audit procedures necessary in connection with the reserve account and the memorandum accounts.

7- 2 What additional auditing procedures should, or might, be undertaken in connection with the confirmation of accounts receivable where customers having substantial balances fail to reply after second-request forms have been mailed directly to them?

7- 3 Describe a sales "cut-off" and indicate the auditing steps you would follow in making a sales "cut-off."

7- 4 Describe the positive methods of confirming accounts receivable by correspondence with debtors. How would you determine which method to use?

7- 5 Describe briefly the more important provisions of a system of internal control in connection with accounts receivable.

7- 6 What would be the effect of each of the following conditions on the auditor's certificate? (a) Accounts receivable are significant in amount, but the client has refused to permit their confirmation by correspondence and no other satisfactory means of establishing their substantial correctness was available. (b) An account receivable, substantial in amount, is owing from a wholly owned subsidiary. The parent company has expressed its willingness to request the subsidiary to confirm the amount of its indebtedness directly to you, but it has refused to give you access to the subsidiary's books and records.

7- 7 You are engaged in an examination of detailed trade accounts receivable for the purpose of appraising the adequacy of the reserve for uncollectible accounts. Indicate points that you would look for in the examination of individual accounts and the conclusions you would draw from them.

7- 8 Submit columnar headings of a worksheet suitable for the control of confirmation requests sent out during the course of your examination of accounts receivable.

7- 9 You are informed by a client that because none of numerous notes from customers is past due, no reserve for bad debts is required. What circumstances might compel you to disagree with him?

7-10 Your client from time to time sells its accounts receivable to a discount corporation, with recourse, 80 per cent of the account being advanced in cash. What balance-sheet notations does this call for, and how would you determine the unpaid accounts at the balance-sheet date?

7-11 What procedure would you follow in reviewing bad-debt write-offs and allowances to customers, authorized and recorded by a cashier-bookkeeper?

7-12 A manufacturer, having in excess of 1,000 active customers, keeps no formal accounts-receivable ledgers because he finds the universal practice among his customers is to pay from the invoice, several invoices frequently being covered by a single remittance. Suggest a number of internal controls that might make up for this absence of customers' ledgers.

7–13 An auditor discovers that a client is making secret rebates to a few large customers in the form of advertising allowances, apparently in violation of the Robinson-Patman act. What do you believe the auditor's responsibility should be under such circumstances?

7–14 A review by an auditor with a manufacturer's sales manager of the principles followed in granting terms to customers reveals that a number of "sales" during the year have actually been consignments—mostly of heavy farm equipment which country dealers have been unable to pay for until sales to farmers have been made. The farmer usually buys on the installment plan, the installment paper is sold to finance companies, with recourse on the manufacturer and dealer, and from the proceeds the manufacturer is reimbursed. What possible adjustment in the manufacturer's accounts will this practice necessitate, and how will the manufacturer's balance sheet be affected?

7–15 What is the meaning of "accrued" when applied to receivables and payables?

7–16 Consult other texts on the preferred position in the income statement of (a) bad debts and (b) cash discounts on sales. State your own opinion.

7–17 Prepare a narrative on the bad-debt analysis shown on page 89 which will serve to explain to the president of the company the computation of the bad-debt reserve at the year end.

7–18 Determine the probable sources of the unpaid balance of the following customer's account at March 31:

Date	Invoice number or source	Debit	Credit	Balance
1–1	Balance forwarded			574.84
1–18	2301	244.21		819.05
1–19	2387	872.58		1,691.63
1–28	Cash		267.84	1,423.79
1–30	2862	450.00		1,873.79
2–12	Cash		539.33	1,334.46
2–13	Discount		4.88	1,329.58
2–15	Return		53.50	1,276.08
2–20	Cash		500.00	776.08
3–4	3945	2,871.40		3,647.48
3–5	Allowance on claim		174.52	3,472.96
3–8	Cash and discount		198.06	3,274.90
3–9	Discount chargeback	3.50		3,278.40
3–15	Cash		201.75	3,076.65
3–16	4624	847.20		3,923.85
3–24	Cash		830.26	3,093.59
3–25	5766	38.50		3,132.09
3–31	Discount		16.94	3,115.15

7–19 To what extent may the auditor rely on a test circularization of customers' accounts made during the year by the client's internal auditor?

8- 1 A mercantile company has consistently valued its inventory on the basis of cost or market, whichever is lower. At the close of the year under examination it changed from the "first-in-first-out" to the "last-in-first-out" method of determining cost. As the result of the change, the net income and federal income taxes have been substantially reduced. How should the change be disclosed in the auditor's report?

8- 2 A client asks your advice with respect to the preparation of instructions to his staff for an inventory-taking and related work, which you are to observe as an independent auditor. What matters would you cover in your advice to him?

8- 3 What special procedures should an independent auditor adopt in the observance of inventory-taking involving large quantities of packaged materials stacked in solid formation?

8- 4 What are the features especially to be noted in the auditor's observation of a physical inventory, and what is the purpose of each such procedure?

8- 5 How may an auditor test for raw-material overstock in a manufacturing business where perpetual-inventory records are kept?

8- 6 What valuation of repossessed merchandise would you approve?

8- 7 Part of the inventory of the E Company at June 30, 1946, was also on hand at June 30, 1945. On the latter date the cost of this portion of the inventory was reduced to market but, during the year following, the market price rose to a figure exceeding original cost. The company has restored original cost in the June 30, 1946, inventory. Give reasons for or against this procedure.

8- 8 In determining a cost base for inventory items manufactured during the past year, you have encountered the following items of cost in the factory accounts; indicate whether or not you would include them in the base, and give a supporting reason in each case: (a) overhead during shutdown caused by factory rehabilitation; (b) award by labor board of increased wages for prior year; (c) employee training; (d) rejects; (e) loss on canceled purchase commitments.

8- 9 Name five desirable internal controls governing inventories, the presence of which aids the auditor in his work.

8-10 How would you dispose of the following problems that have been referred to you in connection with a client's physical inventory of raw materials, the count having been completed two weeks ago, or four weeks before the end of the fiscal year?

(a) Temporary quantity controls were set up for keeping track of new acquisitions and issues of raw materials but a portion of these controls has been accidently destroyed.

(b) A possibility of duplication in count is indicated by the addition of a certain raw material to the temporary quantity controls equal in amount and identical in description with an item reported by the receiving room at the time of the physical count.

(c) Not included in the count are amounts of a certain material, payment for which has already been made. You find that the supplier has agreed to make shipment whenever required but has not set aside in his warehouse any specific quantities earmarked for your client.

8–11 A manufacturer of stove parts, mostly castings, maintains several retail branches in a large city. Part of the goodwill of the company depends on its asserted ability to supply grates, doors, lids, and other frangible parts of any model of "furnace or kitchen stove manufactured during the past 80 years." In producing most parts it has been found by experience that a "run" from 10 to 20 identical castings in the foundry costs little more, except for raw material, than a run of, say, a half dozen. Consequently, an auditor's examination of perpetual inventory records at the end of 1946 has revealed several thousand items similar to the following:

Part Number	Year made	Sales—each 1943	1944	1945	1946	Original cost each (in dollars)	Last mark-down stage	On hand 12–31–46
DS-46 G 008	1930	0	0	0	0	.494	5	9
DS-46 J 891	1942	2	0	0	0	.472	3	5
DS-47 K 891	1943	1	3	0	0	.495	2	8
DS-49 S 453	1945	–	–	1	0	.648	1	11
DS-46 J 846	1946	–	–	–	5	.821	1	15

For some years the company's valuation policy on such items has been annually to mark down cost wherever during any of the four preceding years (including the current year) there have been no sales, by applying to the remaining unit cost the next higher markdown-stage percentage as shown in the following table:

Number of "stage"	Age not more than (years)	Carrying cost: expressed as a percentage of cost brought forward	
1	1	100	The balance remaining when an item has reached the sixth stage (5.04%) is deemed to be not in excess of its worth as scrap
2	1–2	80	
3	2–3	70	
4	3–4	60	
5	4–5	50	
6	over 5	30	

You are required (a) to value and extend the inventoriable cost of the above six items and (b) to set forth your opinion of the propriety of the method.

8–12 Describe briefly how a storekeeper will operate under an established "minimum-maximum" policy.

8–13 Why should the costs incurred on a maintenance work order, only half completed, be "cleared to expense"?

8–14 What are the conditions under which a commitment will be regarded as a contingent liability?

9– 1 A corporation temporarily invested some of its funds in stocks of other companies listed on established exchanges. In the course of your preliminary work you ascertain that all such stocks were acquired at various dates during the year under examination through a brokerage firm, and that the stock certificates are in the name of the corporation (your client) but are being held in safekeeping by the brokerage firm referred to. The corporation does not maintain an investment ledger. You are requested to outline the audit procedure for the examination of the stocks and the income therefrom as reflected in the books of the corporation.

9– 2 To what points should the auditor direct his attention in the examination and verification of bonds and mortgages held by his client as an investment?

9– 3 A company you are auditing has a number of investments in marketable securities. Outline the form of a worksheet that the company's controller has agreed to prepare for you.

9– 4 How would you spread the cost of an investment under any of the following conditions?

(a) A stock dividend of 50 X-company common shares is received on a holding of 150 X-company common shares.

(b) A stock dividend of 50 X-company preferred shares is received on a holding of 150 X-company common shares.

(c) A dividend of 37.5 Y-company common shares is received on an investment of 150 X-company common shares, following a court order compelling the disposition of the Y-company shares.

(d) In a reorganization, Z-company bonds and common stock are received in exchange for X-company common stock.

9– 5 On the books of a company you are examining you find an investment of $100,000 labeled "Eastwood Chemical Company"—a corporation that went out of existence 20 years ago. You are informed that this investment was made originally for the purpose of acquiring a valuable trade name. What would be the nature and purpose of your inquiries on this item?

9– 6 A note receivable from a customer is secured by 100 shares of stock of another corporation. The customer fails to pay and the stock is transferred to the creditor. What should be the basis of valuation on the creditor's books?

9– 7 In determining the propriety of the continued valuation at cost of an investment by your client in 25% of the common capital stock of the Playders Corporation, the suggestion is made that you visit the Playders office and make such inquiries as you may think necessary. Access to the books and other records may be had, if necessary. What would be the nature of your investigation, and what particular points would you look for?

9– 8 In prospectuses filed with the SEC, the financial statements of a holding company are required to be included, in addition to consolidated statements. What is the reason for this practice? Do you believe the practice should also be followed by such corporations in their annual reports to stockholders?

9– 9 May an advance to an affiliate be regarded as a current asset on a nonconsolidated balance sheet?

9–10 The Federal Power Commission permits power companies to defer extraordinary expenses, such as fire losses, and has often approved a company policy of charging such a loss to a "deferred-asset" account and amortizing it over a period of, say, ten years. Its reason for continuing this practice is that it does not wish to burden ratepayers for any one year with a large loss. Is this a valid argument? Discuss.

9–11 Under what conditions would you be likely to pass without comment a failure on the part of the management of a manufacturing enterprise to set up unexpired insurance as a deferred expense?

9–12 State briefly the distinctions between prepaid expenses and deferred charges and how a separate classification on the balance sheet for these items might be eliminated.

9–13 Improvements made by a lessee on a plant it has leased for a 10-year period have not been amortized over that period (which ends two years hence) but have been depreciated on a 30-year basis—their normal economic life. What are your reasons for agreeing or disagreeing with this procedure?

9–14 The corporate owner of a certain parcel of land on December 31, 194- leased it for 20 years to a mining company which is removing mineral deposits from it. Under the terms of the lease, the lessee paid $10,000 at the date the lease was signed, and has paid thereafter "advance rentals" of $12,000 on the first of January each year. In addition, a royalty of $5.00 accrues for each 1,000 pounds of mineral removed from the property, but this amount may be credited against the "advance rentals" of the year of production and the next proximate year; if the royalties exceed the rentals, the established excess will be paid when the following year's "advance rentals" are paid. During the five calendar years over which the lease has been in effect the lessee has certified to the lessor (your client) the following production in pounds: 2,640,000, 2,630,000, 2,040,000, 2,390,000, and 3,100,000. You are asked (a) to set up a schedule, suitable for your permanent file, in which from year to year the facts relating to the lease can be recorded and which will serve to support the record of cash received from the lease, (b) to fill in the schedule for the five-year period with such figures as you would expect to find recorded on the books under the circumstances described, and (c) to state the amounts relating to the lease that would appear in the income statement of the fifth year and in the balance sheet at the end of that year.

10– 1 What audit procedures are required with respect to the following: (1) additions to property accounts of a manufacturing company during the year under review—the items to be considered comprise property additions (a) constructed by a company using construction work-order records, (b) acquired by direct purchase from outside vendors, and (c) acquired through consolidations; and (2) retirements of property of a manufacturing company during the year under review? State in your answers sources from which you would expect to obtain needed information.

10– 2 You are examining annual financial statements that are to be published for the information of the company's stockholders. You find that depreciation charged against income differs from the depreciation deduction in the federal income-tax returns. What would you do about it?

10– 3 What audit procedures are required with respect to the verification of real estate owned by a real-estate company whose accounts have never previously been audited?

10– 4 For what purpose and in what manner does the auditor study depreciation accounts?

10– 5 Under what conditions would you approve additions to fixed assets in the form of overhead charges on construction work undertaken by the company whose accounts you are examining?

10– 6 How would you satisfy yourself as to the adequacy of a reserve for depreciation on motors where the ratio of the accumulated reserve to the cost of the motors is 22 per cent? The motors, approximately 2,000 in number, are attached to and run individual machines in a large machine shop and are replaced at the rate of about 100 a year.

10– 7 For what points would you look in scanning a maintenance and repair account?

10– 8 State how you would satisfy yourself as to the propriety of a provision for depreciation, during the past year, on factory machinery.

10– 9 Under what circumstances, if any, may capital expenditures be charged against revenue expenditures?

10–10 What are the factors to be considered in determining a lower-than-cost policy for stand-by machinery? If it should be decided that such equipment is to be written down would you recommend that a credit be made to the asset account or to the related reserve for depreciation?

10–11 Section 124 of the Federal Internal Revenue Code (income-tax law) deals with the subject of wartime amortization. Since the effect of accelerated depreciation, which led to lower income-tax liabilities during the war, will have important effects on balance sheets and income statements for many years to come, every auditor should have a good working knowledge of the subject. Read Section 124 and the related regulations of the Bureau of Internal Revenue (pp. 514–540 of Regulations 111) for the purpose of answering the following questions.

(a) What was the amortizable period?

(b) To what capital assets was the privilege of accelerated depreciation applicable?

(c) Was the computation in any way dependent on the condition of the property at the end of the war?

(d) May a beneficiary under this section restore excessive depreciation allowances, during the useful life of the property after the war, and thus raise depreciation expense in tax returns for postwar years?

10–12 The net assets of a going corporation are sold for cash, without interruption of business, to a new corporation, the consideration amounting to 150% of the net worth of the old company. To the cost thus incurred the new company has added the face amount of payables assumed and from the total has deducted amounts for cash, receivables, and inventories; the balance remaining is charged to "Plant" account. You are called in to advise with the president and controller of the new company on depreciation policy. Indicate the lines along which you would proceed, and the likely policy you would recommend.

10–13 In adding a wing to a factory building, a wall of the old building is torn down. What entry, if any, would you recommend to record the demolition?

10–14 The management of a company has followed a rigid policy of capitalizing all tools and maintaining a control or inventory card for each item. The difficulty of keeping a separate card on which cost and location appear for each hand tool and similar inexpensive item has proven to be out of proportion to any possible savings or accuracy that may have arisen from the process. As the company's auditor, your advice is sought as to whether good accounting demands that whatever method of control is adopted for small tools be linked to the accounting records by quantity or dollar amount or both, with the same degree of precision, say, as that with which records of raw materials are maintained. What would be your answer?

10–15 By what different methods in current use are maintenance expenses differentiated from plant additions?

10–16 Audit procedure Number 10 under fixed assets refers to the possible disclosure of construction "contract balances in financial statements." When is such disclosure necessary? Draft a disclosure of this type and indicate where it should appear.

10–17 Define a "lapsing schedule" and indicate the method by which it operates. What are the principal reasons for and against the use of such a schedule?

10–18 Name the four most important steps you would take in "verifying" depreciation provisions for a year under audit.

10–19 You find that on the books of a certain oil-producing company, recoveries from the sale of second-hand equipment are credited against current provisions for depletion. What are your objections, if any, to this procedure?

11- 1 Outline an audit procedure for cash discounts (a) on sales and (b) on purchases.

11- 2 Indicate the steps necessary to establish that the amount of trade accounts payable—reflected in the balance sheet—is correct insofar as it relates to merchandise included in the balance sheet on the basis of a physical inventory taken as at the date of the balance sheet.

11- 3 Describe the usual documents constituting a voucher authorizing payment of an amount owed for materials purchased by a manufacturing concern. What authorizations and checks would you expect to find on these documents under a proper system of internal control?

11- 4 Write an audit program covering current liabilities of a medium-sized manufacturing corporation.

11- 5 Your client keeps accounts on an accrual basis and maintains an invoice register in which invoices are entered when they become liabilities. What procedure would you follow in examining this register and supporting records for a selected month in the year under review?

11- 6 Indicate the accounts and the basis of the amounts to be debited and credited, provided any adjustment at all is to be made in the accounts, for each of the following unrecorded items relating to investments or long-term obligations: (a) cash dividend on stock owned, declared before, but not receivable until after end of year; (b) interest received on government bond held by company's sinking-fund trustee; (c) bank balance, representing bond interest past due, for which coupons have not yet been presented, of company's paying agent.

11- 7 During an audit of the accounts of a corporation, you become aware of a claim against the company that you think is likely to be paid but that the directors do not recognize and for which they will set up no liability. What would you do under the circumstances?

11- 8 You find that the contingent assets of a company are in excess of its contingent liabilities. An officer of the company argues that this condition eliminates the necessity of displaying contingent liabilities on the balance sheet as heretofore. Do you agree?

11- 9 Distinguish between current liabilities, fixed obligations, long-term debt, accrued liabilities, and liability reserves.

11-10 Describe a number of terms and conditions under which short-term loans are made by banks to commercial enterprises.

11-11 In determining a client's liability on consignments, what elements enter into the computation and how would you test or verify the accuracy of these elements?

11-12 A number of debit balances are discovered in the creditor's ledger of a large retail store. You are informed that they have resulted from the payment of invoices before the receipt or inspection of merchandise purchased in order to take advantage of discount privileges, and you are given a file containing the invoices "prepaid." In testing the accuracy of these debit balances, what procedure would you follow?

11–13 Your client, a distributor, has a number of traveling representatives to whom cash advances are made averaging $500 each. Every month or so each representative files an expense report and he is reimbursed promptly for the expenses he has incurred. Often a representative is negligent in the filing of his report and the reimbursement request may amount to several thousand dollars. As at the audit date and during the month thereafter several reports had not been rendered. What action would you take as auditor in order to determine the company's liability to these representatives, and what minimum internal controls should be instituted for this type of expense? On the balance sheet would you show the advances as an asset and the full amount of the estimated or actual payment to be made as a current liability?

11–14 Shortly before the end of the year the board of directors of a corporation declared a dividend in owned government bonds, payable on January 15 to common stockholders. How should the dividend be valued, and how should the liability appear on the balance sheet?

11–15 A manufacturer of a household device guarantees its product to operate satisfactorily for one year after the date of sale (through independent local dealers) to the consumer. The consumer is required to mail back a postcard direct to the manufacturer as soon as his equipment is satisfactorily installed. What tests would you apply to the controller's accrual of the estimated liability? Would you insist on an accrual for each unit (a) produced, (b) sold to a dealer, or (c) sold by the dealer to the consumer? Should the unit estimate include full costs (imperfect units are shipped back to the factory by the consumer) or simply the likely cost of parts requiring replacement?

11–16 Procure a Federal income-tax return blank (Form 1120) for corporations, covering the current taxable year and, after carefully reviewing it, answer the following questions:

(a) What five items (there will, of course, be more) of income or expense appear to differ from the usual accounting treatment thereof?

(b) What credits are allowed against "net income" before the tax is computed?

(c) How is "net income" reconciled with the balance sheet?

(d) How is the tax computed?

11–17 To what items would you pay attention in examining reacquired bonds which have been purchased direct from bondholders?

11–18 Explain how you would establish the propriety of a bond-premium account on the books of the creditor where a number of bonds have been repurchased during the year.

12– 1 State the factors to be determined by an auditor as a basis for satisfying himself as to the correctness of the earned surplus shown in the financial statements of a company.

12– 2 On July 31, 194–, a business was converted from a partnership to a corporation. You have regularly made the examination of the financial statements of this business as of December 31 of each year and are requested again to examine them for the current year. As compared with the auditing procedures followed in examinations of prior financial statements, state those you would eliminate or add for purposes of the latter examination.

12– 3 How would you verify treasury stock as shown by the client's records?

12– 4 What do you understand by the term "secret reserves"? Give instances of the manner in which they might be created. What attitude should the auditor have toward them?

12– 5 By means of a reduction during the year in the stated value of its no-par common stock, a company has absorbed a large deficit existing at the beginning of the year. A net profit results from the year's operations. How would you state these facts on your balance sheet at the close of the year?

12– 6 Name four types of restrictions on the use of earned surplus for cash dividends.

12– 7 What is the preferred treatment in financial statements of the following matters relating to a contingency reserve: (a) provision creating the reserve; (b) position of reserve on balance sheet; and (c) expenditures relating to contingent liability against which the reserve was created?

12– 8 A corporation owns nearly all of a block of land. The remaining portion is purchased subject to an existing lease. The corporation sets aside out of earned surplus an amount believed to be sufficient to extend the plant over the entire block at the expiration of the lease. What ledger title should be given to the amount set aside, and how should the amount be shown on the balance sheet?

12– 9 You are employed to make an audit by a stockholder who believes the management of the corporation is piling up large secret reserves with the view of buying up the stock of the minority holders. You are given free access to the books. Indicate the nature of the investigation you would make to determine the truth or falsity of this belief.

12–10 What is a stock dividend? From what sources may it arise? Does the declaration of such a dividend imply that the previous surplus of the corporation has been unreasonably large and not necessary to the business?

12–11 You are making an annual audit of a partnership. To what extent, if any, will you examine the withdrawal accounts of the partners?

12–12 During the current year, an officer of a corporation was given an option to purchase at any time during the next five years 14,000 shares of the Company's common stock at $15 per share, the option being granted at a time when the current market price of the stock on a national exchange was $25 and the book value of the stock was $18. A few months later the officer exercised a part

of the option by purchasing 3,000 shares for cash, the market value at that time being $21. How should these transactions be recorded?

12–13 If preferred methods of accounting are to be followed, what will charges against paid-in surplus be limited to?

12–14 On a certain date the net worth of a corporation was as follows:

Preferred stock: 10,000 shares, par $100		$1,000,000.00
Common stock: 100,000 shares, stated value $1		100,000.00
Paid-in surplus on—		
Preferred stock	150,000.00	
Common stock	400,000.00	550,000.00
Earned surplus		752,861.12
Total net worth		$2,402,861:12

On the same date 1,000 shares of preferred stock were purchased at $125 per share (accrued dividends were previously paid to date), and 1,000 shares of common stock were purchased at $3.50 per share; both reacquired lots were carried as treasury stock. Restate net worth by giving expression to these transactions. What would be the effect on net worth if the alternative method mentioned in this chapter were followed?

12–15 What is the objection on the part of accountants to the showing of unpaid subscriptions as an account receivable?

12–16 Explain the meaning of "legal" capital.

12–17 Ascertain the restriction on the use of the term "quasi reorganization" by the Securities and Exchange Commission and on the expansion of its meaning proposed by the Committee on Accounting Procedure of the American Institute of Accountants.

12–18 Under what conditions may the identity of an earned-surplus account be continued from one corporation to another?

12–19 Restate the principal arguments against the creation and use of mixed reserves.

12–20 In ascertaining the book value per share of common stock would you include mixed reserves?

12–21 Several methods in current use for determining the percentage of "return on the investment" differ from each other because of varying theories of what constitutes "investment." All of them start with the par or stated value of capital stock, and various adjustments have been suggested, as follows:

Additions	Reductions
Paid-in surplus	Dividends paid during year
Valuation surplus	Valuation in excess of original cost
Earned surplus at beginning of year	Goodwill
One-half the current year's profits	
Earned surplus at end of year	

What is your opinion on each of these items?

13- 1 The employees of a company are paid in cash once a week. The company has 200 employees, all of whom work at one plant; 50 of these employees are on a night shift. They are paid on Friday (on Saturday morning with respect to the night crew) for the week ended on the preceding Tuesday. One employee, the payroll clerk, prepares the payroll from time sheets signed by foremen; he also checks time cards against these payroll sheets and hands out the pay envelopes. Prepare an audit program for such a payroll, assuming an annual audit is in progress.

13- 2 In a detailed audit, you are examining an expenditure voucher covering the purchase of supplies; how would you determine whether the purchase was authorized, the goods were ordered, and the goods were received?

13- 3 In the course of an annual audit, the examination of detailed transactions for one month, as agreed upon, has brought to light many clerical errors of importance. What steps should you now take?

13- 4 A certain public accountant who at one time insisted on the necessity of annually examining at close range all the transactions of his clients for one or two months has now substituted an intensive review of internal controls. He states that (a) his auditors are thus encouraged to do a more workmanlike job and (b) each year, instead of indiscriminately covering arbitrarily selected periods, they make detailed examinations at points which need them. Discuss this point of view.

13- 5 It is often claimed that a detailed audit makes it possible "to ascertain whether prescribed operating procedures are being followed." Contrast, and evaluate in general terms, the auditor's methods of carrying out a "procedural review" as described in Chapter IV and the methods of performing a detailed audit as described in this chapter.

13- 6 One auditor claims that his clue for whatever detailed audit he makes for a client is secured from a comparison of trial-balance items over a period of years. What does he mean by this statement and what weakness is inherent in this type of "spot" audit?

13- 7 What are the advantages of making an annual detailed audit of, say, two months' transactions *within* the period under review?

13- 8 Every business enterprise employs some form of internal voucher "audit" before bills are paid. This may be accomplished by a "voucher clerk" who collates voucher information and formally prepares the voucher document, or by an audit clerk or unit that examines the completed voucher, after supporting papers have been attached by a voucher clerk. Your advice is sought by a client as to the position in the office organization in which this audit function should be located. What would your answer be?

13- 9 What internal controls should prevent the payment of the same invoice twice?

13-10 The purchases division of a parts-supply company, because of a shortage of specialists in certain fields, has delegated authority for the purchase of a certain line of merchandise to the head of the division responsible for the selling of the same merchandise. If the practice is to go on, what internal controls should be established in order to insure the continued propriety of this arrangement?

13-11 Suggest the procedure you would adopt in connection with your discovery of the following facts having to do with payrolls:

(a) The factory superintendent hires employees, determines their compensation, and delivers biweekly payroll checks to them in person.

(b) Unclaimed checks are returned by the superintendent to the payroll clerk who keeps them until they are called for; he has on hand checks two and three years old.

(c) Weekly attendance summaries are prepared by foremen and initialed by the superintendent, and, because of these approvals, the payroll clerk makes no comparison of the summaries with clock cards.

(d) In some instances the superintendent has informed the payroll clerk orally as to changes in rates of pay.

(e) "Informal" leave is frequently granted by the superintendent, without notations thereof on the attendance summaries or other payroll record.

13-12 Certain deductions made from the pay of approximately two thirds of the employees of a company apply against purchases of United States Savings Bonds. Devise a simple procedure for recording these deductions and for providing an adequate bookkeeping support for the balance-sheet liability account called "Deductions from Payrolls for U. S. Bonds."

13-13 A petty-cash fund of $2,500 is maintained by one of your clients out of which only expense advances are supposed to be made. You find that in addition to making expense advances the petty cashier has cashed personal checks as an accommodation and that on the day of your examination there are two such checks (one issued by an officer) amounting to $1,200, both postdated, making up a part of the fund. What action on your part does this situation demand, assuming that the practice has been going on for several years?

13-14 Tests applied to a cash-disbursements book reveal errors of footings on two pages, one being overstated $100, and the other understated by $180. The general ledger, however, appears to be in balance. Prepare a program for whatever detailed audit you think the situation warrants.

13-15 In examining the sales account of a truck-repair contractor you discover that a block of 100 customer-invoice copies is missing and in this block you have reason to believe that irregularities in the way of arbitrary overcharges (offsetting peculations of the cashier) may be found. No sales journal is maintained, postings to customers' accounts being made directly from the invoice copies. Explain how you would proceed to investigate the situation.

14- 1 What do you understand by the term "management's representation"?

14- 2 On the basis of an examination completed in accordance with the audit program described hereinafter, would the auditor be warranted in giving a certificate covering the fairness of the statement of the income account for the period? Explain. The audit program provides for the following but no more: (1) a detailed examination of all the profit-and-loss accounts by reference to vouchers in support of substantially all transactions appearing in the respective accounts in the general ledger; (2) a check of the clerical accuracy of all the books of original entry and accounts in the general ledger; (3) a comprehensive proof of cash for the period under review.

14- 3 Briefly describe the audit procedure that suggests itself in the examination of (1) tuition income of private schools; (2) rental income of office buildings; (3) annual dues of golf clubs; (4) donations received by charity organizations; and (5) plate collections at church services.

14- 4 Explain the purpose of a client's written representations to an auditor in connection with the verification of financial statements.

14- 5 Completing today an audit for the past year, you are scanning briefly your client's books of account since the year end. Name six events (differing from those appearing on page 189) that might have occurred during that period which would warrant disclosure in your report.

14- 6 Draft language suitable for inclusion in a letter of representation to you from your client, in connection with an annual audit, covering (a) inventories and (b) fixed assets.

14- 7 Outline the qualities you believe to be necessary to a good worksheet supporting a balance-sheet item in an annual audit.

14- 8 Devise sideheads or footnotes that will provide adequate disclosure in a balance-sheet of the following inventory items:

(a) Raw materials were last physically inventoried two years ago, additions and deductions since that time having been made on a cost basis—i.e., purchases at invoice cost and issues at a "moving-average" cost. No allowance has been made for shortages, obsolescence, or deterioration.

(b) In-process inventory is valued at cost, as revealed by cost sheets showing material charged thereto, and labor, but no overhead.

(c) Finished goods have been priced at standard cost. Material, which constitutes roughly two thirds of prime cost, is underpriced one-fourth; labor, one-tenth; and overhead, which for standard-cost purposes has been computed as 100% of direct-labor standard cost, one-half.

14- 9 Prepare adjusting journal entries, in a form suitable for inclusion in working papers covering a calendar-year audit, to give effect to the following unrecorded items:

(a) No inventory of office supplies had been taken for some years and, at the suggestion of the auditor, the office manager prepared and priced a physical list of stationery and similar items on hand on March 31 (three months after the close of the audit year), the

total as thus determined being $12,483.35. Errors discovered by the auditor in extensions and footings reduced this figure by $347.50; pricing errors caused additional reductions of $162.18. Since the beginning of the year purchases have been $3,672.27, and estimated issues $1,500.00.

(b) In the process of verifying working-fund advances to employees at distant points, the auditor finds that the following expenses, paid for from these advances, had not been given expression on the home-office books: traveling expenses (sales), $410.28; traveling expenses (engineering and research), $388.25; salary of engineering assistant, $275.00.

(c) A factory machine was scrapped having an original cost of $2,289.40. The machine, in an asset account with several hundred others, had been purchased exactly seven years ago; and the freight and installation, amounting to $120.50, was at that time expensed. The asset account was the basis for composite depreciation of 10% until two years ago; for the past two years the composite rate has been 8%.

(d) A dividend of $1.25 on common stock was declared by the board of directors on December 31, payable on February 15 to stockholders of record on January 20, the resolution indicating a total of $12,500. However, on December 31, 350 shares out of 10,000 outstanding a year prior was being held by the company as treasury stock. Of these 350 shares, 140 shares were sold on January 14 (two weeks later) at the then listed market price.

(e) Interest of $1,468.75 had been received by the trustee of a "voluntary" pension fund. The fund is shown on the company's balance sheet as an asset and is offset by a "pension-fund reserve" of equal amount, carried as appropriated earned surplus.

14–10 On January 31, one month following an audit but several weeks before the completion of an annual audit, a company enters into an agreement with the Federal Bureau of Internal Revenue whereby an additional income-tax assessment of $12,525.00 becomes the final amount due on a tax return filed two years prior. No liability has been set up for this amount. Is it the auditor's duty to adjust for the additional assessment or to indicate the amount, as a contingency, in a footnote?

14–11 Your client has purchased a "war plant" from the Federal Defense Plant Corporation at approximately "15 cents on the dollar," or $60,000. This plant is well suited to your client's manufacturing requirements and adaptation costs are not expected to exceed $10,000. Your advice is sought on revaluation. Cost now under reasonable postwar conditions of a similar plant would be around $250,000, and a suggestion has been made by the president that $200,000 would be a conservative figure after deducting "observed" depreciation. What is your reaction to this proposal?

15- 1 The accountant's short-form report contains the words "supporting evidence." State three different types of such evidence and give examples of each type.

15- 2 An auditor's report may contain certain qualifications or exceptions. State three of the more important of these and suggest suitable language for them.

15- 3 What are the essential elements of an auditor's certificate?

15- 4 Analyze and discuss briefly the following sentence, which constitutes a part of the standard audit certificate: "Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary."

15- 5 The vice-president in charge of the credit department of a bank, having been given a copy of a customer's annual report you have just completed, asks you to confer with him on certain questions that he feels that you, with your knowledge of the business, can easily answer for him. In view of the confidential relationship between the professional accountant and his client, would you feel free to answer the banker's questions?

15- 6 You have certified to the financial statements of a manufacturing concern and have been asked by a stockholder why you have certified as to their correctness when some of the assets are known by the stockholder to be stated at figures in excess of their realizable (i.e., present sales) value. What reply would you make?

15- 7 Should an auditor attempt to eliminate the unauthorized use of his reports and certificates?

15- 8 Name several operating and financial ratios that may be of interest to readers of a long-form audit report, indicating in each case the significance of the ratio.

15- 9 The following excerpt was taken from a long-form report: "The petty-cash fund of $200 was counted and found to be short $1.23." Would you have mentioned the shortage?

15–10 Why is it desirable to include in a long-form report a statement of the insurance in force? Should the auditor also present his conclusions as to whether the company is adequately protected?

15–11 The standard form of audit certificate is shown on page 208. Often the accountant will add to the scope and opinion paragraphs. Classify these additions by their general character.

15–12 In preparing a certificate, an auditor is confronted with the following items which he has recognized as possible causes of certificate changes in the case of a corporation having total assets of $1,000,000. Give your opinion on each, suggest the language to be used if the certificate is to be modified, and indicate the place of such language in the certificate:

(a) A subsidiary company in Italy lost most of its assets in the war. In the interest of conservatism, the parent company had previously written down its investment in the subsidiary to a nominal sum of $10; since the war it has made a single advance to the subsidiary of $40,000 which it carries without diminution on its books. A financial statement, translated into dollars at the current exchange rate, was prepared at the parent's balance-

sheet date by Italian accountants; it shows net current assets of $24,600, net fixed assets of $3,100, and a liability to the parent company made up of net assets remaining after the war, $2,558, advances since the war from the parent, $40,000, and an operating deficit since October 1, 1945 (when it started up its postwar business) of $14,858 which included an operating loss for the past year of $4,705. No contingent liability of the parent company appears to exist because of the subsidiary's operation.

(b) A physical inventory of finished goods totaling $12,500 was taken but the auditor was not present. However, he has determined that as a rule the amount of finished goods on hand is negligible since a long line of customers has been awaiting the company's product for several years.

(c) A bond indenture provides that the working-capital ratio shall be maintained at not less than 3 to 1, and the ratio has fallen to something less than 2 to 1. Although failure to live up to this rule can be regarded as a technical default, an officer of the trustee bank informs the auditor that the remedy provided in the indenture is somewhat obscure, and that, under the circumstances, with the company making a profit and fully operating, and with no other specific default, no action will be taken by the trustee.

15–13 In referencing a report in a public-accounting office, would you rely primarily on the fact that the typed matter agrees with the working trial balance or would you refer to specific working papers?

15–14 Compare the relative advantages of the short-form and long-form audit report.

15–15 A statement of application of funds often features a long-form report. The form is flexible, and that appearing in the report draft of the Illustrative Audit (LP-6) could have been considerably expanded. Redraft the form in such a manner as to add the following elements: (a) sales and other gross income, (b) cost of sales by objects and other principal classes of expense, and (c) principal items of working capital. Make sure that these added elements tie in with the financial statements.

Index